Internal Revenue Service

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Washington, DC 20224

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Person To Contact:
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TY:

Legend

Taxpayer =

Preparer X =

Preparer Y =

Company =

D =

Year 1 =

Year 2 =

$a =

$b =

$c =

Dear :

This is in response to your letter dated requesting permission to revoke an election under section 1.163(d)-1(c) of the Income Tax Regulations to treat qualified dividend income and net capital gain as investment income under sections 163(d)(1) and 163(d)(4)(B) of the Internal Revenue Code for Year 1.

FACTS

Taxpayer is in the real estate building and construction business. Taxpayer hired Preparer X to prepare their Year 1 tax return. In Year 1, Taxpayer was a D% shareholder of Company, an S corporation. Taxpayer reported passthrough income of $a from Schedule K-1 as non-passive income on the Taxpayer's Schedule E, Supplemental Income and Loss. Taxpayer paid $b of interest related to debt proceeds used by Taxpayer to purchase Company stock. The interest was deducted on Form 4952, as investment interest expense. Based on advice of Preparer X, Taxpayer made the decision to elect to include $c of qualified dividend income and net capital gains as investment income for purposes of deducting investment interest expense.

Taxpayer hired Preparer Y to prepare their Year 2 income tax return. Preparer Y informed Taxpayer that the Year 1 interest expense should have been reported as business interest expense. Therefore, the Year 1 election to treat qualified dividends and net capital gains as investment income was not necessary.

APPLICABLE LAW

Section 163(d)(1) provides that, in the case of a taxpayer other than a corporation, the amount allowed as a deduction for investment interest shall not exceed the net investment income of the taxpayer for the taxable year.

Section 163(d)(4)(B) defines investment income, in general, as the sum of –

(i) gross income from property held for investment (other than gain taken into account under clause (ii)(I)),

(ii) the excess (if any) of

(I) the net gain attributable to the disposition of property held for investment, over

(II) the net capital gain determined by only taking into account gains and losses from dispositions of property held for investment, plus

(iii) so much of the net capital gain referred to in clause (ii)(I) as the taxpayer elects to take into account under this clause.

Section 163(d)(4)(B) also states that such term shall include qualified dividend income (as defined in section (1)(h)(ii)(B)) only to the extent the taxpayer elects to treat such income as investment income for purposes of this subsection.

Section 1.163(d)-1(b) of the Income Tax Regulations provides that the election under section 163(d)(4)(B) must be made on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized or the qualified dividend income is received.

Section 1.163(d)-1(c) of the regulations provides that the election under section 163(d)(4)(B) is revocable with the consent of the Commissioner.

Notice 88-37, 1988-15 I.R.B. 8, 1988-1 C.B. 522, provides guidance with respect to reporting of interest expense with respect to debt-financed acquisitions and debt-financed distributions involving partnerships and S corporations for taxable years beginning after December 31, 1986. Under Notice 88-37, interest expense allocated to a trade or business expenditure (within the meaning of section 1.163-8T(b)(7)) of a passthrough entity should be reported in Part II of Schedule E.

Notice 89-35, 1989-13 I.R.B. 4, 1989-1 C.B. 675, provides guidance on the allocation of interest expense in certain transactions involving partnership and S corporations and the allocation of interest expense on debt proceeds received in cash or deposited in an account. Under Notice 89-35, debt proceeds used to purchase an interest in a passthrough entity (other than by way of a contribution to the capital of the entity) will be allocated, along with the associated interest expense, among all the assets of the passthrough entity using any reasonable method. Reasonable methods of allocating debt proceeds among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets of the passthrough entity.

Taxpayer is requesting permission to revoke its election to include qualified dividend income and net capital gains in investment income. This situation is analogous to those situations concerning taxpayers who have not made a particular election provided in the regulations because of inadequate or incorrect advice from knowledgeable tax professionals and are subsequently seeking extensions of time under section 301.9100-3 of the Procedure and Administration regulations. Rev. Rul. 83-74, 1983-1 C.B. 112.

Section 301.9100-3 of the regulations generally provides extensions of time for making regulatory elections. For this purpose, section 301.9100-1(b) defines the term “regulatory election” to include an election whose deadline is prescribed by a regulation, a revenue ruling, revenue procedure, notice or announcement published in the Internal Revenue Bulletin.

Section 301.9100-3 provides that requests for extensions of time for regulatory elections will be granted when the taxpayer provides evidence (including affidavits described in the regulations) to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and granting relief will not prejudice the interests of the government.

Section 301.9100-3(b)(1) states that a taxpayer will be deemed to have acted reasonably and in good faith if the taxpayer-

> (i) requests relief before the failure to make the regulatory election is discovered by the Service;

(ii) inadvertently failed to make the election because of intervening events beyond the taxpayer's control;
(iii) failed to make the election because, after exercising due diligence, the taxpayer was unaware of the necessity for the election;
(iv) reasonably relied on the written advice of the Service; or
(v) reasonably relied on a qualified tax professional, and the tax professional failed to make, or advise the taxpayer to make, the election.

In this case, Taxpayer may be considered to have acted reasonably and in good faith because Taxpayer relied on a qualified tax professional who advised Taxpayer to make the election.

Under section 301.9100-3(b)(3), a taxpayer will not be considered to have acted reasonably and in good faith if the taxpayer--

(i) seeks to alter a return position for which an accuracy-related penalty has been or could be imposed under section 6662 at the time the taxpayer requests relief (taking into account section 1.6664-2(c)(3) of the Income Tax regulations) and the new position requires a regulatory election for which relief is requested;
(ii) was informed in all material respects of the required election and related tax consequences, but chose not to file the election; or
(iii) uses hindsight in requesting relief. If specific facts have changed since the original deadline that make the election advantageous to a taxpayer, the Service will not ordinarily grant relief.

In this case, Taxpayer is not seeking to alter a return position for which an accuracy-related penalty has been or could be imposed under section 6662 at the time relief is requested. Furthermore Taxpayer is not using hindsight in requesting relief. Specific facts have not changed since the filing of the return and making of the original election that made the election disadvantageous to Taxpayer.

Section 301.9100-3(c)(1)(i) provides, in part, that the interests of the government are prejudiced if granting relief would result in the taxpayer having a lower tax liability in the aggregate for all taxable years affected by the election than the taxpayer would have had if the election had been timely made (taking into account the time value of money). Section 301.9100-3(c)(1)(ii) provides, in part, that the interests of the government are ordinarily prejudiced if the taxable year in which the regulatory election should have been made, or any taxable years that would have been affected by the election had it been timely made, are closed by the period of limitations on assessment. Under these criteria, the interests of the government are not prejudiced in this case. Allowing Taxpayer to revoke its election would not result in Taxpayer having a lower tax liability in the aggregate for all taxable years affected by the election than it would have had if the election had not been timely made (taking into account the time value of money). Furthermore, the taxable year in which the regulatory election that is sought to be

revoked here, and any taxable year affected by it, is not closed by the period of limitations on assessment.

In addition, granting the revocation in the present situation would not cause undue administrative burden, nor would it be inconsistent with the objectives of the underlying statute and the regulatory election.

Accordingly, the consent of the Commissioner is hereby granted to revoke the election under section 163(d)(4)(B) to include $c of qualified dividend income and net capital gain as investment income for Year 1. The extension of time to revoke this election shall be for a period of 60 days from the date of this ruling and is to be made by filing an amended return for Year 1.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed on whether $b of the interest expense would qualify as deductible business interest expense. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling. The rulings contained in this letter are 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 request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Christopher F. Kane
Branch Chief, Branch 3
(Income Tax & Accounting)