Internal Revenue Service

Number: **200610002**
Release Date: 3/10/2006
Index Number: 1362.04-00

Department of the Treasury
Washington, DC 20224

Person To Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2 – PLR-128113-05
Date:
November 23, 2005

Legend

X =

A =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

Year 2 =

Year 3 =

a =

Dear

This letter responds to a letter dated May 2, 2005, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on Date 1 and is wholly owned by A. X elected to be an S corporation effective Date 2. X had subchapter C earnings and profits at the close of each of its Year 1, Year 2, and Year 3 taxable years, and had gross receipts for each of those years more than 25 percent of which were passive investment income. As a result, X's S election terminated on Date 3.

X represents that the termination of X's election to be an S corporation was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. X and A agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.

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

Section 1361(b)(1)(B) provides that a "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not 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.

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 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) shall be 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).

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or § 1362(d)(3); (2) the Secretary determines that the circumstances resulting in such 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 of the corporation at any time during the period specified under § 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 for that period, then, notwithstanding the circumstances resulting in such termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1368(c) provides rules for determining the source of distributions made by an S corporation having accumulated earnings and profits with respect to its stock. Section 1368(e)(3) and § 1.1368-1(f)(2)(iii) of the Income Tax Regulations provide that an S corporation may, with the consent of all of its affected shareholders, elect to distributed earnings and profits first.

Section 1.1368-1(f)(3) provides that an S corporation may elect to distribute all or part of its 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 § 1368(e)(3) and § 1.1368-1(f)(2)(iii) to distribute earnings and profits first.

Section 1375 provides that if for the taxable year an S corporation has- (1) accumulated earnings and profits at the close of such taxable year, and (2) gross receipts more than 25 percent of which are passive investment income, then there is 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).

Section 1375(b)(1)(B) provides that the amount of the excess net passive income for any taxable year shall not exceed the amount of the corporation's taxable income for such taxable year as determined under § 63(a)—(1) 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. The information submitted by X indicates that X had no taxable income for Year 1 and Year 2.

Based solely on the representations made and the information submitted, we conclude that X's S corporation election terminated on Date 3 under § 1362(d)(3)(A), because X had subchapter C earnings and profits at the close of each of three consecutive taxable years, and had gross receipts for each of those taxable years more than 25 percent of which were passive investment income.

We further 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 Date 3, and thereafter, provided that X's S corporation election was valid and has not otherwise terminated under § 1362(d) and provided that the following conditions are met. Within 60 days from the date of this letter, X shall file an amended return for the Year 3 taxable year, electing pursuant to § 1.1368-1(f)(3) to make a deemed dividend distribution of $a. Also within 60 days from the date of this letter, A shall amend A's individual Year 3 income tax return to reflect the changes made to X's Year 3 return. If these conditions are not met, then this ruling is null and void. Furthermore, if these conditions are not met, X must notify the Ogden Service Center with which X's S corporation election was filed that its election terminated on Date 3. Based on the particular facts of this case, no adjustments are required under § 1362(f)(4).

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, including whether X was or is a small business corporation under § 1361(b).

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to X's authorized representative.

Sincerely yours,

J. Thomas Hines
Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

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