Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:3 / PLR-127677-04

Date:
April 11, 2006

Company:

Shareholders:
Director:

State:

a:

b:

c:

d:

e:

f:

g:

Dear :

This letter responds to a letter from your authorized representative dated May 10, 2004, 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, as well as a ruling under § 1375(d) waiving the tax imposed by § 1375(a).

FACTS

Company represents that its S election was effective on a and that it has filed its tax returns consistent with S corporation status (other than with respect to its passive investment income and the tax under § 1375) since that time. Company also represents that its shareholders have included their distributive shares of Company's taxable income or loss as reported to them by Company since a.

In b, a C corporation merged with and into Company. Company was unaware that, as a result of this merger, it had accumulated earnings and profits (E&P) since b. The outside accountants who prepared Company's income tax returns for tax years before c failed to inform Company or its new accountants of any E&P. In addition, Company's income tax return for d indicated that Company had no E&P. Not until they were preparing Company's income tax return for e did Company's new accountants discover, in the course of obtaining certain tax information from the former accountants, the existence of E&P. Shortly thereafter, Company distributed all of its E&P to Shareholders.

Company represents that for the tax years f, it had both E&P at the close of each year, and gross receipts more than 25 percent of which were passive investment income. Thus, Company's S corporation election terminated as of g.

Company and its Shareholders agree to make any adjustments during the termination period (consistent with the treatment of Company as an S corporation) as might be required by the Service.

LAW

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 those tax years more than 25 percent of which are passive investment income.

Section 1362(f) provides that if (1) 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) 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) 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.

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. In the case of a transfer of stock to an ineligible shareholder that causes an inadvertent termination under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of an S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent any loss of revenue due to a transfer of stock to an ineligible shareholder (e.g., a transfer to a nonresident alien).

Section 1375(a) provides that, if for the tax year an S corporation has (1) accumulated earnings and profits (E&P) at the close of that tax 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 the corporation for that year, computed by multiplying the excess net passive income by the highest rate of tax specified in § 11(b).

Section 1375(d) provides that, if the S corporation establishes to the satisfaction of the Secretary that (1) it determined in good faith that it had no E&P at the close of a tax year, and (2) during a reasonable period of time after it was determined that it did have E&P at the close of that tax year the E&P were distributed, the Secretary may waive the tax imposed by § 1375(d) for that year.

Section 1.1375-1(d)(2) provides that a request for waiver of the tax imposed by § 1375 shall be made in writing to the district director and shall contain all relevant facts to establish that the requirements of § 1.1375-1(d)(1) are met.

CONCLUSION

Based on the facts and representations submitted by Company, we conclude that the termination of Company's S corporation election on g due to excess passive investment income was inadvertent within the meaning of § 1362(f). Consequently, we rule that Company will continue to be treated as an S corporation from g, and thereafter, unless Company's S election otherwise terminates under § 1362(d).

Having determined that Company satisfied the requirements of § 1375(d), the Service, by letter from the Director dated March 22, , has waived the tax imposed by § 1375(a) for any tax year before . This waiver will not cover any future years where additional C corporation earnings and profits might be acquired by Company.

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 or implied regarding Company's eligibility to be an S corporation.

Under a 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,

/s/

JEANNE SULLIVAN
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: Copy of this letter
Copy for § 6110 purposes

cc: