Internal Revenue Service

Number: **200709017**
Release Date: 3/2/2007
Index Number: 1362.04-00

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:B01
PLR-127751-06
Date: November 30, 2006

Legend:

X =
EIN:

State =

D1 =

D2 =

a =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

D3 =

Dear :

This responds to the letter dated May 10, 2006, and related correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code ("Code") for an inadvertent termination of S election.

FACTS

The information submitted states that X was incorporated under the laws of State on D1. X elected to be treated as an S corporation for federal tax purposes, effective D2. At the time of the election, X has $ *a* in accumulated earnings and profits ("CE&P"). For each of the consecutive years of Year 1, Year 2, and Year 3, X had passive investment income in excess of 25 percent of its yearly gross receipts.

After the death of the sole shareholder of X in Year 4, the tax professionals of X became aware that X's S election had been terminated. X represented that all relevant returns have been filed and taxes paid (including the tax under § 1375) consistent with the treatment of X as an S corporation.

LAW AND ANALYSIS

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 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 the taxable years more than 25 percent of which are passive investment income. The termination is effective on and after the first date of the first taxable year beginning after the third consecutive taxable year referred to in § 1362(d)(3)(A)(i). § 1362(d)(3)(A)(ii).

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, annuities, and sales or exchanges of stock or securities.

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 consent, or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the 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 this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as

an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such termination, such 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) provide that an S corporation may, with the consent of all its affected shareholders, elect to distribute 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) to distribute earnings and profits first.

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)).

CONCLUSION

Based solely upon the representations made and the information submitted, we conclude that X's S election terminated on D3.

We further conclude that the termination of X's S election was an inadvertent termination within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation on and after D3, unless X's S election is 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 income tax return for Year 3, electing pursuant to § 1.1368-1(f)(3) to make a deemed dividend of $ *a*. Also, within 60 days from the date of this letter, the Year 3 income tax return of the sole shareholder of X must be amended to reflect the changes made to the Year 3 income tax return of X. If these conditions are not met, then this ruling is null and void.

Except as specifically ruled upon above, no opinion is expressed as to the federal income tax consequences of the facts described above under any other provision of the code.

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

In accordance with the Power of Attorney on file with this office, copies of this letter ruling will be sent to your authorized representatives.

Sincerely,

David R. Haglund
Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

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