Internal Revenue Service

Number: **200802027**
Release Date: 1/11/2008

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:03
PLR-149251-06
October 15, 2007

LEGEND

Taxpayer =

State =
Corporation =
D1 =
D2 =
D3 =
a =
b =
YR1 =
YR2 =
YR3 =
YR4 =
YR5 =
Shareholder =

Dear :

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

FACTS

According to the information submitted, Corporation was incorporated under the laws of State on D1. In late YR1, Corporation amended its articles of incorporation to change

its name to Taxpayer, and effective D2, Taxpayer elected to be treated as an S corporation for Federal tax purposes. At the time of the election, Taxpayer had C corporation accumulated earnings and profits ("CE&P") of $ a. For each of the consecutive years of YR2, YR3, and YR4, Taxpayer had passive investment income in excess of 25 percent of its yearly gross receipts.

In YR5, when Taxpayer obtained new representation in connection with a transaction conducted by Taxpayer's sole shareholder, Taxpayer became aware that Taxpayer's S election had terminated on D3. To correct the error, Taxpayer distributed all of its accumulated CE&P to Shareholder in YR5 and elected to distribute CE&P first for YR5 pursuant to §1.1368-1(f) of the Income Tax Regulations. Taxpayer promptly requested this ruling.

Taxpayer represents that the termination of its S election was inadvertent, and that no tax avoidance will result if Taxpayer is treated as continuing to be an S corporation from the date of its inadvertent termination due to excess passive investment income. Taxpayer and Shareholder agree to make adjustments during the termination period (consistent with the treatment of Taxpayer as an S corporation) as might be required by the Service.

LAW

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

Section 1362(f) provides in part 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 the 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 pursuant to § 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 with respect to this period, then, notwithstanding the circumstances resulting in the 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) 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 on the representations made and the information submitted, we conclude that X's S corporation election terminated on D3 under § 1362(d)(3)(A) because X had subchapter C earnings and profits at the close of each of three consecutive taxable years beginning in YR2, and 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). Pursuant to the provisions of §1362(f), X will be treated as continuing to be an S corporation beginning on D3 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. As an adjustment under § 1362(f)(4), X must send a payment of $ b with a copy of this letter to the following address: Internal Revenue Service, Cincinnati Service Center, M/S 280G, Cincinnati, Ohio, 45999. X must send this payment no later than 30 days from the date of this letter.

If all of the above conditions are not met, then this ruling is null and void. Furthermore, if these conditions are not met, X must notify the Cincinnati Service Center that its S corporation election has terminated.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code.

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.

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

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.

Sincerely,

/s/

Tara P. Volungis
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)