Internal Revenue Service

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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:B03
PLR-133389-07

Date:
December 19, 2007

LEGEND

X =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

A =

Shareholders =

$a =

Dear :

This responds to a letter dated July 19, 2007, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X was incorporated on Date 1 in State. A, X's president and principal operating officer, elected for X to be treated as an S corporation effective Date 2. A became permanently disabled during Year 1. In the consecutive taxable years of Year 2, Year 3, and Year 4 through the present taxable year, X received passive investment income (within the meaning of § 1362(d)(3)) in excess of 25% of gross receipts. Furthermore, X accumulated earnings and profits (AE&P) between Date 1 and Date 2 and has carried the accumulated AE&P from Date 2 to present.

X represents that the termination of its S election was inadvertent and not the result of tax avoidance or retroactive tax planning. X and its shareholders have consistently treated X as an S corporation and agree to make any adjustments consistent with the treatment of X as an S corporation that may be required by the Secretary.

LAW AND ANALYSIS

Section 1361(a)(1) defines “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% of which are passive investment income. Section 1362(d)(3)(A)(ii) provides that 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).

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 consents, or (B) was terminated under paragraph (2) or (3) of § 1362(d), (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 such ineffectiveness or 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 § 1362(f), 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 ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations 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 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% of which are passive investment income (within the meaning of § 1362(d)(3)).

CONCLUSIONS

Based solely on the representations made and the information submitted, we conclude that X's S election terminated on Date 3, under § 1362(d)(3)(A), because X had accumulated earnings and profits at the close of each of three consecutive tax years beginning Year 2, and had gross receipts for each of those years more than 25% of which were passive investment income.

We further conclude that the termination of X's S election was inadvertent 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 Date 3 and thereafter, unless X's S election is otherwise terminated under § 1362(d), provided that the following conditions are met. By Date 4, X must distribute its AE&P pro rata to Shareholders. Shareholders must report their pro rata shares of this distribution as a dividend on their federal tax returns for the year ending Date 4. Further, X must send a payment of $a with a copy of this letter to the following address: Internal Revenue Service, Cincinnati Service Center, M/S 343G, Cincinnati, OH 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 the election has terminated.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion concerning whether X's S corporation election was a valid election under § 1362.

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

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

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/

James A. Quinn
Senior Counsel, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: