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.

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Refer Reply To:
CC:PSI:B01
PLR-121911-10

Date:
November 19, 2010

LEGEND

X =

D1 =

D2 =

D3 =

D4 =

Year 1=

Year 2=

Year 3=

State =

Dear

This responds to a letter dated May 17, 2010, submitted on behalf of X by X's authorized representative, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code (the Code).

FACTS

According to the information submitted and representations within, X was incorporated on D1, under the laws of State. Effective D2, X elected to be taxed as an S corporation.

For X's tax years ending Year 1, Year 2, Year 3, and for other subsequent years to date, X's passive investment income exceeded 25% of its gross receipts. Furthermore, X had accumulated earnings and profits (AE&P) for each of the years stated above. As a result, X's S election terminated on D3.

X represents that it has always intended to maintain its S corporation status and that the termination of X's S election was inadvertent and did not involve retroactive tax planning or tax avoidance. X further represents that X and its shareholders continued to consistently treat X as an S corporation and that X and its shareholders agree to make any adjustments required as a condition of obtaining relief under the inadvertent termination rule as provided under § 1362(f) of the Code that may be required by the Secretary. In addition, X represents that it incurred losses in all years at issue.

LAW AND ANALYSIS

Section 1361(a)(1) of the Code provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation (I) has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and (II) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

Section 1362(d)(3)(C)(i) provides that except as otherwise provided in § 1362(d)(3)(C), the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, and annuities.

Section 1362(f) provides, in relevant part, that if (1) an election under § 1362(a) by any corporation 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); (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 so that the corporation for which the termination occurred is a small business corporation; and (4) the corporation for which the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments (consistent with the treatment of such 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, such corporation shall be treated as an S corporation

during the period specified by the Secretary.

Section 1.1362-4(b) provides, in relevant part, 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, in the case of a termination, was not part of a plan to terminate the election, or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination of the election 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.

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)).

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)--(i) 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 all years at issue.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated on D3, the first taxable year after three consecutive years in which X had accumulated earnings and profits, and also in which more than 25 percent of its income was passive activity income under § 1362(d)(3)(A. We further conclude that the termination of X's S election on D3 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 and after D3, unless X's S corporation election is otherwise terminated under § 1362(d), and provided that X distributes its AE&P pro rata to its shareholders by D4 and the shareholders report their pro-rata shares of this distribution as a dividend on their federal tax returns.

Except as specifically ruled upon above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the

Code. Specifically, we express or imply no opinion regarding X's eligibility to be an S corporation.

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.

Pursuant to the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely,

Faith Colson
Faith Colson
Senior Counsel, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: