Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01
PLR-107758-05
Date:
March 25, 2005

Legend:

X =

Y =

Z =

A =

B =

Trust =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

$a =

Dear :

This letter is in response to your request, dated December 30, 2004, on behalf of X, seeking inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

Facts

Based on the materials submitted and representations within, we understand the relevant facts to be as follows. X was incorporated on Date 1 in accordance with the laws of State. X made an election to be treated as an S corporation effective Date 1. All of the stock of X was owned by Y, prior to a tax-free split-off of X pursuant to §355. After the reorganization, all of X's stock was owned by A and Trust. X's business facilities are maintained and operated by Z, which is taxed as a partnership and owned by A and B. New accountants for X determined that the activities performed by Z could not be attributed to X. Thus, in the consecutive taxable years ending Date 2, Date 3, and Date 4, X received passive investment income (within the meaning of § 1362(d)(3)) in excess of 25 percent of its gross receipts. Furthermore, X had accumulated earnings and profits (AE&P) retained in each of these three years from Y. As a result, X's S election terminated effective on Date 4.

Based on its new accountant's analysis, X discovered that it had inadvertently terminated its S corporation status. X requested this ruling shortly thereafter, and distributed $a, a figure which represents the entire amount of AE&P held by X. X and its shareholders represent that each will file an amended return for the taxable year ending Date 2, Date 3, and Date 4 to reflect the additional tax owed pursuant to § 1375.

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 (A and Trust) 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 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). Section 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 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.

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 effective Date 4 because X had AE&P at the close of each of three consecutive tax years and had gross receipts for each of those tax years more than 25 percent of which were passive investment income.

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 Date 4, unless X's S election is otherwise terminated under § 1362(d).

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. In particular, no opinion is expressed or implied as to whether X otherwise qualifies as a subchapter S corporation under § 1361, or whether or not the reorganization was tax-free under § 355.

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, a copy of this letter ruling will be sent to your authorized representative.

Sincerely,

/S/ Dianna K. Miosi

Dianna K. Miosi
Chief, 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: