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Legend

X =

Y =

State =

D1 =

D2 =

D3

Year1

Year2

Year3

Year4

Dear

This letter responds to the letter dated January 30, 2006, submitted on behalf of X, requesting a ruling 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 D1 , under the laws of the State. Effective D2, X elected to be taxed as an S corporation.

In the consecutive taxable years of Year1, Year2, and Year3, X received passive investment income (within the meaning of § 1362(d)(3)) in excess of 25% of its gross receipts. Furthermore, X had accumulated earnings and profits (AE&P) remaining in each of these three years. In Year3, X undertook investments to ensure that its passive investment income would not be in excess of 25% of its gross receipts. In Year4, X discovered that the investments undertook in Year3 had not produced the nonpassive gross receipts anticipated and that X had inadvertently terminated its S corporation status as of D3. X requested this ruling soon after discovering that its S election had terminated.

It is represented that X paid the tax imposed by § 1375 for Year1 and Year2 and that no tax was imposed under § 1375 for Year3 because X had no taxable income for Year3. It is further represented that to ensure that X's election will not again terminate as a result of excess passive investment income, the shareholders of X will contribute the stock of X to Y, a related operating S corporation, and make a qualified subchapter S subsidiary election for X as of the date of contribution.

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 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% of which are passive investment income. The termination is effective on and after the first date of the first tax year beginning after the third consecutive tax 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 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) 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% 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 Year3.

Conclusions

Based solely on the representations made and the information submitted, we conclude that X's S election terminated on D3, under § 1362(d)(3)(A), because X had accumulated earnings and profits at the close of each of three consecutive tax years beginning Year1, 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 D3, and thereafter, provided that X's S election was valid and is not otherwise terminated under § 1362(d).

This ruling is contingent on the shareholders of X contributing the stock of X to Y and making a qualified subchapter S subsidiary election for X effective the date of contribution with the appropriate service center within 60 days of the date of this letter.

Except as specifically ruled upon above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, no opinion is expressed on whether X was otherwise eligible to be treated as an S corporation.

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

Pursuant to the power of attorney on file with this office, copies of this letter will be sent to X's authorized representatives.

Sincerely,

David R. Haglund
Senior Technician Reviewer
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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