

**Internal Revenue Service**

Number: **200618012**

Release Date: 5/5/2006

Index Number: 1362.04-00, 1362.02-03

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-147871-05

Date:

January 31, 2006

X =

Y =

State =

Shareholders =

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=

=

m =

n =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

d7 =

d8 =

Dear :

This letter responds to your letter dated September 15, 2005, and subsequent correspondence, submitted on behalf of X, requesting a ruling under §1362(f) of the Internal Revenue Code.

### Facts

According to the information submitted, X was incorporated under the laws of State on d1 and elected to be an S corporation effective d1.

On d2, X acquired stock in Y, a C corporation that had m of accumulated earnings and profits. Immediately after the acquisition, X owned all the stock of Y and elected to treat Y as a qualified subchapter S subsidiary of X. At the close of the consecutive taxable years ending d3, d4, and d5, X had accumulated earnings and profits of m, and for each taxable year ending d3, d4, and d5, X received passive investment income (within the meaning of §1362(d)(3)) in excess of 25 percent of its gross receipts. As a result, X's S corporation election terminated on d6.

X recently discovered that its S corporation election terminated on d6 and requested this ruling shortly thereafter. X represents that the termination of its S corporation election was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. X and the 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 as 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 such taxable year.

Section 1362(d)(3)(A)(i) provides that an election under §1362(a) terminates 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 that if (1) an election under §1362(a) by any corporation was terminated under §1362(d)(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), agree to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary regarding 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) of the Income Tax Regulations 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 d6 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 d7, 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 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 d6, 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. Within 60 days from the date of this letter X shall file an amended income tax return for the d8 taxable year, electing pursuant to §1.1368-1(f)(3) to make a deemed dividend of m. Also, within 60 days, the Shareholders of X must amend their d8 income tax returns to reflect the changes made to X's d8 tax return. No amendments shall be made to X's income tax returns for the taxable years ending d3 and d4 with respect to the tax imposed under §1375. However, as an adjustment under §1362(f)(4), X must send a payment of n with a copy of this letter to the following address: Internal Revenue Service, Philadelphia Service Center, Attn: Accounting Branch, Philadelphia, Pennsylvania 19255. X must send this payment no later than 30 days from the date of this letter.

If all the above conditions are not met, then this ruling is null and void. Furthermore, if these conditions are not met, X must notify the Ogden 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.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representatives.

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.

Sincerely,

/s/

Mary Beth Collins  
Senior Technician Reviewer, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

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

cc: