Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-139741-04
Date:
September 29, 2006

Company:

LLC 1:

LLC 2:

M:

Shareholders:	Dates of Ownership

State:

a:

b:

c:

d:

e:

f:

g:

Dear :

We received your letter dated July 2, 2004, and subsequent correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal

Revenue Code that the termination of Company's S corporation election was inadvertent. This letter responds to that request.

FACTS

Company was incorporated on a under the laws of State and elected under § 1362(a) to be an S corporation effective b.

M transferred Company shares to LLC 1 on c. Subsequently, LLC 2 also purchased Company shares. Both LLC 1 and LLC 2 are ineligible shareholders. Company's S corporation election terminated on c.

Company had excess passive investment income for 3 consecutive years (d), within the meaning of §§ 1362(d)(3)(A)(i) and 1375(a).

Company management and internal accounting staff executed the stock transfers. Company's federal tax returns were prepared internally in some years and by outside accountants in other years. Company was unaware that it had ineligible shareholders or excess passive investment income until a new outside accountant identified the issues. Company moved promptly to distribute all of its accumulated earnings and profits, and it submitted this request for inadvertent termination relief.

Company and Shareholders represent that they had no intention of terminating Company's S corporation election. Company and Shareholders agree to make adjustments during the termination period (consistent with the treatment of Company as an S corporation) as might be required by the Service.

LAW

Except as provided in § 1362(g), § 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(b)(1)(B) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1362(d)(2)(A) provides that an election under § 1362(a) terminates whenever the corporation ceases to be a small business corporation.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in 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), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as might be required by the Secretary regarding this period, then, notwithstanding the circumstances resulting in 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 1362(d)(3)(A)(i) provides that an election under § 1362(a) terminates whenever the corporation (I) has accumulated earnings and profits at the close of each of three consecutive tax years, and (II) has gross receipts for each of these tax years more than 25 percent of which are passive investment income.

CONCLUSION

Based on the facts and representations submitted by Company, we conclude that the termination of Company's S corporation election due to the transfer of Company

stock to LLC 1, an ineligible shareholder, was inadvertent within the meaning of § 1362(f). Consequently, upon the conditions prescribed below, we rule that Company will continue to be treated as an S corporation from c, and thereafter, unless Company's S election otherwise terminates under § 1362(d).

As conditions for this ruling –

1) LLC 1 and LLC 2 must not be treated as shareholders for any time they held Company shares. Accordingly, for the time during the termination period that LLC 1 and LLC 2 did hold Company shares, the members of these LLCs shall be treated as shareholders of Company, directly owning Company stock they owned indirectly through the LLCs, as represented by their LLC ownership percentages.

2) Within 60 days of the date of this letter, Company must file an amended return for e, electing under § 1.1368-1(f)(3) to make a deemed dividend distribution in the amount of its accumulated earnings and profits actually distributed in f. Within the same 60 days, except for those Shareholders for whose e tax year the statute of limitations on assessments has expired and who have not filed protective claims for their f tax year, Shareholders must file amended returns for e reporting their shares of Company's deemed dividend distribution.

3) As an adjustment under § 1362(f)(4), Company must send a payment of g to the Internal Revenue Service, P.O. Box 9940, Mail Stop 6271, Ogden, UT 84409.

If the conditions above are not met, this ruling is void, and Company must notify the Ogden Service Center that its S corporation election terminated on c.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed or implied regarding Company's eligibility to be an S corporation.

Under a power of attorney on file with this office, we are sending the original of this letter to you and a copy to Company.

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/
CHRISTINE ELLISON
Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy of this letter
copy for § 6110 purposes

cc: