Internal Revenue Service

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Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01
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Date:
February 22, 2013

LEGEND

X =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

D8 =

Years =

Year1 =
Year2 =

State =

$a =

$b =

$c =

Dear :

This responds to a letter dated August 28, 2012, submitted on behalf of X by X's authorized representative, requesting inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

FACTS

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

For X's taxable years ending D3, D4, and D5, X's passive investment income exceeded % of its gross receipts. Furthermore, X had C corporation accumulated earnings and profits (CE&P) for each of the years stated above. As a result, X's S election terminated on D6.

To correct the error, X made an election under § 1.1368-1(f) of the Income Tax Regulations to distribute all of its CE&P of $a through a deemed dividend in Year2. X represents that it distributed $a throughout Year2. X represents that it owes $b for Years and that it amended its tax return for Year1 and included its payment of $c on D8.

X represents that its previous tax advisor inadvertently failed to inform X of the passive investment rules. In addition, 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 of § 1362(f) that may be required by the Secretary.

LAW AND ANALYSIS

Section 1361(a)(1) 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 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) 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, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

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.

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.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated on D6, because for three consecutive years, X had CE&P and more than percent of X's income was passive activity income under § 1362(d)(3)(A). We further conclude that the termination of X's S election on D6 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 on and after D6, provided X's S corporation election was valid and is not otherwise terminated under § 1362(d).

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,

Joy C. Spies
Joy C. Spies
Senior Technician Reviewer, 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: