

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

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September 25, 2003

Legend

X =

A =

Estate =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

\$a =

Dear :

This letter responds to a letter dated December 11, 2002, 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 on Date 1. A, X's sole shareholder, elected for X to be treated as an S corporation for its taxable year beginning Date 2. A died on Date 3. In the consecutive taxable years of Year 1, Year 2, Year 3, and Year 4, 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 four years. In Year 5, X distributed to Estate \$a, X's entire AE&P, in order to eliminate the excess net passive income tax. In Year 6, X discovered that it had inadvertently terminated its S corporation status on Date 4. X requested this ruling soon after discovering that its S election had terminated.

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 sole shareholder 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. 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 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)).

### Conclusions

Based solely on the representations made and the information submitted, we conclude that X's S election terminated on Date 4, under § 1362(d)(3)(A), because X had accumulated earnings and profits at the close of each of three consecutive tax years beginning Year 1, 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 Date 4 and thereafter, provided that X's S election was valid and is not otherwise terminated under § 1362(d). Based on the

particular facts of this case, no adjustments are required under § 1362(f)(4). Furthermore, no amendments shall be made to X's or Estate's Year 4 income tax returns with respect to the issues addressed in this letter. If these conditions are not met, X must notify the Service Center with which X's S corporation election was filed that the election terminated on Date 4.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the above-described facts under any other provision of the code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) 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 is being sent to X's authorized representative.

Sincerely yours,

James A. Quinn  
Senior Counsel, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

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