

**Internal Revenue Service**

Department of the Treasury  
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Person To Contact:  
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Telephone Number:

Refer Reply To:  
CC:PSI:B02  
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Date:  
April 17, 2009

LEGEND

- X =
- State =
- Date 1 =
- Date 2 =
- Year 1 =
- Year 2 =
- Year 3 =
- a =

Dear :

This responds to the letter dated March 9, 2009, and related correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code ("Code") for an inadvertent termination of S election.

The information submitted states that X was incorporated under the laws of State. X elected to be treated as an S corporation for federal tax purposes effective Date 1. At the start of Year 1, X had approximately \$a of accumulated earnings and profits due to its prior C corporation years. For each of the consecutive years of Year 1, Year 2, and Year 3, X had passive investment income exceeding 25 percent of its yearly gross receipts. Therefore, X's S election terminated on Date 2.

X represents that they were unaware that X had excessive passive investment income for Year 1, Year 2, and Year 3 and that excessive passive investment income could cause the termination of X's S election. Since the discovery of the termination, X took corrective actions so that it would not have excessive passive investment income in the future.

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 percent of which are passive investment income. The termination is effective on and after the first date of the first taxable year beginning after the third consecutive taxable year referred to in § 1362(d)(3)(A)(i). § 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 consent, or (B) was terminated under § 1362(d)(2) or (3), (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 the 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 this subsection, 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 termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

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)).

Based solely upon the representations made and the information submitted, we conclude that X's S election terminated on Date 2, because X had subchapter C earnings and profits at the close of each of the three consecutive tax years, Year 1, Year 2, and Year 3, and had gross receipts for each of those years of which more than 25 percent was passive investment income.

We further conclude that the termination of X's S election on Date 2 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 on and after Date 2, unless X's S election is otherwise terminated under § 1362(d), and provided that the following conditions are met.

Within 60 days of this letter, X shall file amended returns for Year 1, Year 2, and Year 3, and pay the tax imposed under § 1375.

If the above condition is not met, then this ruling is null and void. Furthermore, if these conditions are not met, X must notify Cincinnati Service Center that its S election has terminated.

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

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code 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 ruling will be sent to your authorized representative.

Sincerely,

Melissa C. Liquerman  
Chief, Branch 2  
(Passthroughs & Special Industries)

Enclosures (2)  
Copy of this letter  
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