

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201042010**

Release Date: 10/22/2010

Index Numbers: 1362.04-00, 1375.00-00

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B03
PLR-105516-10

Date:
July 08, 2010

LEGEND

Company =

Shareholders =

State =

Remedial Distributions =

a =

b =

c =

d =

e =

f =

g =

h =

i =

m =

n =

Dear :

We received a letter dated January 29, 2010, and subsequent correspondence, submitted on behalf of Company by its authorized representative requesting a ruling under § 1362(f) of the Internal Revenue Code (Code). This letter responds to that request.

FACTS

According to the information submitted, Company was incorporated under the laws of State in a. Company elected to be an S corporation effective on b.

At the close of three consecutive taxable years ending e, Company had subchapter C accumulated earnings and profits of m. Moreover, for each taxable year ending c, d, and e, Company had passive investment income (within the meaning of §1362(d)(3)) in excess of 25 percent of its gross receipts. As a result, Company's S corporation election terminated on f.

In addition, following its S corporation election, Company made disproportionate distributions to its Shareholders in taxable years i. Company represents that under its governing provisions, all of Company's shares of stock have possessed identical rights to distribution and liquidation proceeds since b. Company further represents that neither Company nor its Shareholders knew that disproportionate distributions could terminate Company's S corporation election. Company will make Remedial Distributions to its Shareholders upon the issuance of a favorable letter ruling.

Company recently discovered that its S corporation election terminated on f and requested this ruling shortly thereafter. Company represents that the termination of its

S corporation election was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. Company and the Shareholders have consistently treated Company as an S corporation and agree to make any adjustments consistent with the treatment of Company as an S corporation as may be required by the Secretary.

LAW AND ANALYSIS

Section 1361(a)(1) provides that for purposes of title 26, 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) provides that for purposes of subchapter S, the term “small business corporation” means 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 one class of stock.

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

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

Passive investment income

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 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).

Section 1362(d)(3)(C)(i) as in effect for taxable years ending c, d, and e, provides, in part, that, except as otherwise provided in §1362(d)(3)(C), the term “passive investment income” means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1375 provides that if for the taxable year an S corporation has accumulated earnings and profits at the close of such taxable year, and gross receipts more than 25 percent of which are passive investment income, then there is hereby imposed a tax on the income of such corporation for such taxable year. Such tax shall be computed by multiplying the excess net passive income by the highest rate of tax specified in section 11(b).

Single class of stock

Section 1.1361-1(l)(1) of the Income Tax Regulations provides, in part, that a corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in § 1.1361-1(l)(4) (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.

Section 1.1361-1(l)(2)(i) provides, in part, that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Inadvertent termination

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in such termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such 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 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 termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Distributions of accumulated earnings and profits

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) 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, in part, that an S corporation may elect to distribute all or part of its subchapter C 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 provided in §1.1368-1(f)(2) (relating to the election to distribute earnings and profits first).

CONCLUSIONS

Based solely on the representations made and the information submitted, we conclude that Company's S corporation election terminated on f, under §1362(d)(3)(A) because Company had subchapter C earnings and profits at the close of each of three consecutive taxable years beginning on b, 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 Company's S corporation election was an inadvertent termination within the meaning of §1362(f). In addition, we waive any termination that would have occurred and any additional tax that would have been imposed under § 1375 due to Company's excessive passive investment income for the consecutive taxable years g.

Pursuant to the provisions of §1362(f), Company will be treated as continuing to be an S corporation beginning on f, and thereafter, provided that Company's S corporation election was valid and has not otherwise terminated under §1362(d) and that the following conditions are met. Within 120 days from the date of this letter, Company shall file an amended income tax return for the h taxable year, electing pursuant to § 1.1368-1(f)(3) to make a deemed dividend of m. Also, within 120 days, the Shareholders of Company must amend their income tax returns for their corresponding taxable years to reflect the changes made to Company's h tax return. No amendments shall be made to Company's income tax returns for the taxable years ending c and d with respect to the tax imposed under §1375. However, as an adjustment under §1362(f)(4), Company must send a payment of n with a copy of this letter to the following address:

Internal Revenue Service
Cincinnati Service Center
201 West Rivercenter Blvd.
Covington, KY 41011
Stop 31
Terri Lackey
Manual Deposit.

Company must send this payment no later than 45 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, Company must notify the Cincinnati Service Center that its S corporation election has terminated.

Finally, we also conclude that if Company's S corporation election was terminated for having more than one class of stock as a result of making disproportionate distributions, such termination constituted an inadvertent termination within the meaning of § 1362(f). Accordingly, Company will be treated as continuing to be an S corporation from the date of its first disproportionate distribution and thereafter, provided that Company's S corporation election is not otherwise terminated under § 1362(d). This ruling is contingent upon Company making Remedial Distributions within 120 days of the date of this letter for taxable years i–taxable years in which it made disproportionate distributions to its Shareholders. The Shareholders of Company must include their pro rata shares of the separately stated and nonseparately computed items of income or loss of Company as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by Company as provided in § 1368. If Company fails to make such Remedial Distributions or Company's Shareholders fail to treat themselves as described above, this ruling shall be null and void.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion regarding whether Company is otherwise eligible to be treated as an S corporation.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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

Sincerely,

/s/

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

Enclosures (2)

Copy of this letter

Copy for §6110 purposes