L. IRC 501(c)(15) - SMALL INSURANCE COMPANIES OR ASSOCIATIONS

1. Introduction

The purpose of this section is to provide some background and an update in the area of IRC 501(c)(15) insurance companies or associations. No prior ATRI or CPE text has included a topic in this area.

2. Exemption Provisions

A. Background

The typical insurance company or association recognized as exempt under IRC 501(c)(15) is a mutual organization which provides its members with property damage coverage. Membership is often limited by the organization to residents of a particular county. Burial and funeral benefit companies providing their benefits in the form of supplies and services may also qualify under IRC 501(c)(15). If benefits are paid in cash upon the death of the insured, the organization is deemed a life insurance company and exemption is not appropriate under IRC 501(c)(15), but may be considered under IRC 501(c)(12) as a local benevolent life insurance association. As noted below, exemption under IRC 501(c)(15) was recently extended to include marine insurance companies.

B. Exemption Provisions Prior to Tax Reform Act of 1986

(1) Prior to the enactment of the Tax Reform Act of 1986 ("the Act"), IRC 501(c)(15) provided that a mutual insurance company or association (other than life or marine) or a mutual interinsurer or reciprocal underwriter (other than life or marine) could be exempt under IRC 501(a) if the gross amount received from certain items during the taxable year did not exceed $150,000. These items of income consisted of:

(a) Premiums, including deposits and assessments;

(b) Interest, dividends, rents and royalties;

(c) Amounts received for entering into leases, mortgages, or other instruments or agreements from which the company or association may receive interest, rents or royalties;

(d) Amounts received for altering or terminating instruments or agreements of the type described in (3); and

(e) Gross income from a business (other than the insurance business) carried on by the company or association or by a partnership of which the company or association is a member.

(2) Although neither IRC 501(c)(15) nor the underlying regulations discuss the concept of mutuality, Rev. Rul. 74-196, 1974-1 C.B. 140, provides that the following characteristics, while not alone conclusive, must be present:

(a) **Control by members** - Membership must be limited to policyholders and all policyholders must be members. Furthermore, all policyholders must have the right to choose the management of the organization.

(b) **Providing insurance at cost** - The company must provide insurance at substantially its cost, allowing for reasonable reserves against its policy obligations and operational expenses. An unreasonable accumulation suggests that the company is not providing insurance to its members substantially at cost. Reserves maintained for business expansion would not be considered appropriate.

(c) **The right of members to excess premiums** - The excess of the premium over actual cost and reserves, as later ascertained, must be returned to the policyholder. This may take the form of a reduction in renewal premiums or the payment of dividends on the policies.

(d) **Common equitable ownership of assets by members** - This is evidenced by the right of members to receive the company's net assets in the event the members vote to wind up and dissolve the company.

C. Exemption Provisions Pursuant to the Act

The Act amended IRC 501(c)(15) with respect to taxable years beginning after December 31, 1986. The changes pertain to:

(1) **Operation as a mutual organization** - An exempt insurance company or association is no longer required to operate on a mutual basis. It may now operate on a stock basis or a mutual basis.

(2) **Coverage** - An exempt insurance company or association may now issue marine coverage. Life insurance coverage remains a prohibited activity.

(3) **Nature of receipts and ceiling** - An insurance company or association may qualify as exempt if its net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000. The items of income discussed above in 2.B.(1) (other than premiums) are not taken into account for purposes of this test.

The legislation did not define "net written premiums" or "direct written premiums." However, a manual published by the National Association of Insurance Commissioners provides some guidance in this area. Direct written premiums include premiums arising from policies issued by the company acting as the primary insurance carrier. Net written premiums are equal to direct premiums plus the reinsurance assumed premiums, less the reinsurance ceded premiums.

D. Legislative History Regarding the Act

The portion of Conference Report No. 99-841, 1986-3 C.B. II 370, Vol. 4, regarding the changes discussed above follows:

7. Special exemptions, rates, and deductions of small companies

Present Law

Under present law, mutual property and casualty companies are classified into three categories depending upon the amounts of the gross receipts. Mutual companies with certain gross receipts not in excess of $ 150,000 are tax-exempt (sec. 501(c)(15)). Companies whose gross receipts exceed $ 150,000 but do not exceed $ 500,000 are "small mutuals" and generally are taxed solely on

investment income. This provision does not apply to any mutual company that has a balance in its PAL account, or that, pursuant to a special election, chooses to be taxed on both its underwriting and investment income. Additionally, small mutuals which are subject to tax because their gross receipts exceed $ 150,000 may claim the benefit of a special rule which phases in the regular tax on investment income as gross receipts increase from $ 150,000 to $ 250,000. Companies whose gross receipts exceed $ 500,000 are ordinary mutuals taxed on both investment and underwriting income. Mutual reciprocal underwriters or interinsurers are generally taxed as mutual insurance companies, subject to special rules (sec. 826).

Like stock companies, ordinary mutuals generally are subject to the regular corporate income tax rates. Mutuals whose taxable income does not exceed $ 12,000 pay tax at a lower rate. No tax is imposed on the first $ 6,000 of taxable income, and a tax of 30 percent is imposed on the next $ 6,000 of taxable income. For small mutual companies which are taxable on investment income, no tax is imposed on the first $ 3,000 of taxable investment income, and a tax of 30 percent is imposed on taxable investment income between $3,000 and $6,000.

Mutual companies that receive a gross amount from premiums and certain investment income of less than $ 1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $ 6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

House Bill

The House bill provides that mutual and stock property and casualty companies are eligible for exemption from tax if their net written premiums or direct written premiums (whichever is greater) do not exceed $500,000.

In addition, the House bill repeals the special rates, deductions and exemptions for small mutual companies and substitutes a single provision (sec. 847 of the Code). The new provision allows mutual and stock companies with net written premiums or direct written premiums (whichever is greater) in excess of $ 500,000 but less than $ 2 million to elect to be taxed only on taxable investment income. To determine the amount of direct or net written premiums of a member of a controlled group of corporations, the direct or net written premiums of all members of the controlled group are aggregated.

The provisions are effective for taxable years beginning after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill, except that the $ 500,000 threshold is reduced to $ 350,000 and the $ 2 million threshold is reduced to $ 1,200,000. The provisions are effective for taxable years beginning after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, effective for taxable year beginning after December 31, 1986, with the modification that, in determining whether a taxpayer is a member of a controlled group of corporations for purposes of eligibility for the provision, a 50 percent ownership test applies.

Parts II and III of Subchapter L of the Code are consolidated into Part II, under the conference agreement. Part II of Subchapter L relates generally to taxation of property and casualty insurance companies.

3. Current Topic of Interest

As discussed above, the Act has significantly changed IRC 501(c)(15) with respect to the nature of receipts which must be considered for purposes of the newly-defined ceiling which was itself increased to $350,000. The result is that this ceiling takes into account only net written premiums (or, if greater, direct written premiums). Premiums collected in a prior year, although they pertain to coverage in the current year, are not considered for purposes of the current year's ceiling amount. In addition, income from sources other than insurance activity is no longer taken into account for purposes of the ceiling.

These changes in the law can cause a dramatic change in the federal income tax liability faced by an insurance company. To illustrate, assume that an insurance company realized net written premiums of $500,000 in 1986 and $350,000 in 1987 and that all premiums came from policies which provide two years coverage. Assume further, underwriting expenses of $50,000 each year, interest income of $50,000 each year and that the company delays its sale of an investment from which a gain of $1,000,000 is realized from 1986 to 1987.

	1986	1987
Net written premiums	$ 500,000	$ 350,000
Amortization of unearned premium	-250,000	-175,000
Recognition of earned premium from prior year		+250,000
Earned premiums	**$ 250,000**	**$ 425,000**
Underwriting expense	- 50,000	- 50,000
Net Underwriting income	$ 200,000	$ 375,000
Investment income	+ 50,000	+1,050.000
Net income	**$ 250,000**	**$ 1,425,000**

Under IRC 501(c)(15), as amended, the company will qualify as an exempt organization described therein for 1987 since its net written premiums do not exceed $350,000. Treasury is concerned about the potential for significant tax revenue losses and is considering seeking remedial legislation.

4. Application for Exemption

An applicant for recognition of exemption under IRC 501(c)(15) should file Form 1024, Application for Recognition of Exemption, with its key District Director. Reg. 1.501(a)-1(b)(1)(i) provides that an applicant must also submit copies of the policies or certificates of membership issued by it. Also see also IRM 7668.6 which will be modified to reflect the recent amendment of IRC 501(c)(15).