

Audit Technique Guide – Small Insurance Companies or Associations – IRC Section 501(c)(15)

Introduction

This Audit Technique Guide includes information for identifying and developing issues during the examination of an organization recognized as exempt from federal income tax under IRC Section 501(a) and under IRC Section 501(c)(15) as a small insurance company or association.

This guide offers help for examining small insurance companies or associations exempt under IRC Section 501(c)(15) and is not all-inclusive. Its purpose is to supplement other IRM sections and not to restrict you in identifying issues or using examination techniques not included here.

This guide doesn't contain technical information on IRC Section 501(c)(15) organizations. Review the technical information in IRM 7.25.15, Small Insurance Companies or Associations.

Background

IRC Section 501(c)(15) originally granted exempt status to entities referred to as certain mutual insurance companies or associations other than life or marine. The Tax Reform Act of 1986 (TRA 86) eliminated the distinction between small mutual companies and other small companies and extended IRC Section 501(c)(15) to all eligible small companies, whether stock or mutual, other than life.

TRA-86 changed the ceiling amount for tax exemption from certain gross receipts to net written premiums (or, if greater, direct written premiums) which don't exceed \$350,000 per year. This exemption also includes interinsurers and reciprocal underwriters. These changes were effective for tax years starting after December 31, 1986.

Organizational Requirements

Effective for years beginning after December 31, 2003, Section 206 of Public Law 108-218, Pension Funding Equity Act of 2004 (the Act), revised the definition of small property and casualty insurance companies (insurance companies other than life insurance companies) exempt from income taxes. The Act amended IRC Section 501(c)(15) to say that a property and casualty insurance company is eligible to be exempt from federal income tax if:

- Gross receipts for the taxable year don't exceed \$600,000; and
- More than 50 percent of those gross receipts are premiums. See IRC Section 501(c)(15)(A)(i).

Note: For these tests, consider amounts received by all members of the insurance company's controlled group (including foreign and tax-exempt companies). See IRC Section 501(c)(15)(C).

A mutual insurance company is exempt if its gross receipts for the taxable year:

- Don't exceed \$150,000; and
- More than 35 percent of those gross receipts are premiums.

Note: This clause doesn't apply if any employee of the company, or a member of the employee's family (per IRC section 2032A(e)(2)), is an employee of another company exempt from taxation because of this paragraph (or would be exempt, but for this sentence).

Examination Guidelines

The type of examination conducted of an organization exempt under IRC Section 501(c)(15) depends on whether the organization is a stock-owned organization or a mutual type organization.

Examination Guidelines – Stock Owned Organization

Review the operations of stock-owned insurance companies:

- Determine whether the organization is providing insurance.
- Determine that the organization isn't a life insurance company.
- Ascertain whether the organization has annual gross receipts in excess of \$600,000. If so, the organization doesn't qualify for exemption under IRC Section 501(c)(15) for the year under examination.
- If the organization's gross receipts aren't over \$600,000, determine if over 50 percent of the gross receipts consist of premiums. If the premiums don't exceed 50 percent of the gross receipts, the organization won't qualify for recognizing exemption under IRC Section 501(c)(15) for the year under examination.

Examination Guidelines – Mutual Insurance Companies

Review the operations of mutual insurance companies:

- Determine whether the organization is providing insurance.
- Determine that the organization isn't a life insurance company.
- Determine whether the organization has over \$600,000 gross receipts. If so, the organization isn't exempt under IRC Section 501(c)(15) for the year under examination.
- If organization's gross receipts aren't more than \$600,000, determine if more than 50 percent of the gross receipts consist of premiums. If the premiums don't exceed 50 percent of the gross receipts, the organization may still be exempt under IRC Section 501(c)(15) if:
 - The gross receipts don't exceed \$150,000, and
 - premiums exceed 35 percent of the gross receipts

Examination Guidelines – Life Insurance Companies

Review IRC Section 816, which defines a long term life insurance company and creates a mechanical formula for determining if an insurance company is one. Defining a life insurance company takes into account "life insurance reserves" and "unearned premiums and unpaid loss on no cancellable life, accident, or health policies not included in life insurance reserves." A company isn't a life insurance company unless these amounts exceed 50 percent of the total reserves. If the organization is a life insurance company, it can't meet the requirements under IRC Section 501(c)(15). IRC Section 501(c)(15) is only for small property and casualty companies. Life insurance companies are excluded.

Gross Receipts Test

Verify the organization's gross receipts for the taxable year don't exceed \$600,000 and more than 50 percent of those gross receipts consist of premiums.

If the organization is a mutual company and doesn't meet the requirements above, verify that both:

- The organization's gross receipts for the taxable year don't exceed \$150,000.
- More than 35 percent of the gross receipts contain premiums.

Review IRM 7.25.15 and Notice 2006-42, 2006-1 C.B. 878, which define "net written premiums," "direct written premiums," and other pertinent terms.

The \$600,000 gross receipts test includes direct written premiums during a tax year, even though some of this income is not earned premium income for that tax year. In other words, use "premiums written" in calculating, not "premiums earned."

To compute an organization's gross receipts, don't include these:

- Capital losses (but include capital gains)
- Reimbursements from reinsurance companies to cover some or all of the claims paid (These amounts reduce the claims paid, and aren't part of gross receipts)
- So-called "commissions" the organization received from a reinsurance company they're reinsuring a portion of their insurance with. These so-called "commissions" reduce the premiums paid to the reinsurance company and aren't part of the gross receipts.

Controlled Group

The Act retains the controlled group rule and requires aggregating gross receipts with those of other controlled group members per IRC Section 831 and IRC Section 1563. See [IRM 7.25.15.2](#).

Determine if the insurance company is a controlled group member. If so, include the gross income from all other controlled group members in the \$600,000 gross income test.

Transactions Between Related Parties

Review transactions between related parties to determine if there's significant tax avoidance, or if the transactions show a "sham." Review IRC Section 845 on reinsurance agreements between related parties. When tax avoidance or evasion is evident, determine whether a significant tax avoidance effect exists with any insurance company entering into a reinsurance contract that requires adjustments under IRC Section 845(b). The courts have looked at factors to determine whether the transaction was a "sham," including whether:

- The parent formed the captive insurer with a legitimate business purpose
- The captive insurer determined premiums at arm's length that reflect insured's risk history and industry standards
- Indemnification agreements or comfort letters exist that guarantee the performance of a captive insurer
- The captive is thinly or over-capitalized
- The captive's reserves were actuarially determined at a fair and reasonable level and inflated for tax avoidance reasons
- Circular cash flows exist, such as loans from the captive insurer to its parent or other affiliated entity.

Review the governing instruments, and, as part of the initial contact or interview:

- Obtain the shareholders' names and family relationships in the controlled group;
- Determine whether the insurance company insures parties related to its shareholders; and
- Determine whether the insurance company reinsures insurance products produced by entities financially related to its shareholders.

Caution: IRS revoked Rev. Rul. 77-316, 1977-2 C.B. 53, by issuing Rev. Rul. 2001-31, 2001-26 I.R.B. 1348, June 25, 2001. Therefore, an identity of ownership interests between the shareholders of the "producer taxable entities" (in other words, the source of the insurance business) and the insurance company shareholders (or identical shareholders, for that matter) is no longer sufficient without additional facts to justify revoking exemption based on the "producer taxable entity" and insurance company being within the same "economic family;" that is, having identical owners. With the Rev. Rul. 77-316 being revoked, we can no longer use the "economic family" rationale for revoking exemption. Instead, apply the facts and standards in the LeGierse and Malone & Hyde cases (see below). If you're considering revocation, ask TE/GE Division Counsel's advice.

Insurance Contracts

Exemption under IRC Section 501(c)(15) says that an organization's primary and predominant activity must be an insurance company engaged in issuing and servicing insurance contracts. An insurance

contract must shift and distribute a risk of loss, and that risk must be an “insurance” risk, as stated in *Helvering v. LeGierse*, 312 U.S. 531(1941). Also, see Rev. Rul. 89-96, 1989-2 C.B. 114, which holds that the assumption of investment risk can’t create an insurance agreement. Review a sample of the organization’s issued contracts to determine if they qualify as insurance contracts.

Captive Foreign Corporation

Determine whether the insurance company is a captive foreign corporation and whether it has made an election under IRC Section 953(c)(3)(C) or IRC Section 953(d). If so, get a complete copy of that election and determine if it satisfies the annual information requirements of Rev. Proc. 2003-47, 2003-2 C.B. 55.

Note: Rev. Proc. 2003-47 details the required contents of the election. Those contents include both a calculation under the “US Assets Test” and a U.S. shareholders’ list that includes their SSN’s and percentage of ownership interests and addresses. Further, Rev. Proc. 2003-47 requires the company to update the election yearly if there is a change in ownership interests or owners. The insurance company must file a copy of the update with the [Form 990](#), Return of Organization Exempt From Income Tax, in the year of change. IRC Section 1563(b)(2)(c) excludes foreign corporations subject to tax under IRC Section 881 from the controlled group definition and, therefore, would deny exemption under IRC Section 501(c)(15). If the foreign corporation has made an election under either IRC Section 953(c)(3)(C) or IRC Section 953(d), then it isn’t treated as an excluded member under IRC Section 1563(b)(2)(c).

If the insurance company is a captive foreign corporation, determine if it’s operated like the organization described in *Malone & Hyde Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995). The Sixth Circuit concluded since there was no shifting and distribution of the risk of loss to unrelated parties, there was no insurance, and the offshore insurance subsidiary was a sham corporation propped up by its parent.

Note: Per Rev. Rul. 2001-31, 2001-1 C.B. 1348, the IRS may, however, challenge certain captive insurance transactions based on each case’s facts and circumstance. See, for example:

- *Malone & Hyde Inc.*, which concluded that brother-sister transactions weren’t insurance because the taxpayer guaranteed the captive’s performance, the captive was thinly capitalized and loosely regulated
- *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297 (9th Cir. 1987), which concluded that a transaction between parent and subsidiary wasn’t insurance.

Insurance Companies in Liquidation

Insurance companies in liquidation that no longer receive premiums and their main source of income is investment income may qualify for exemption under IRC Section 501(c)(15) if they meet the transitional rule for companies in receivership or liquidation. The transitional rules are for companies that are in a court ordered liquidation or receivership. An organization that is voluntarily liquidating isn’t entitled to the transitional rules.

For insurance companies in liquidation:

- Review the court documents to determine the date on which the insurance company could no longer write insurance.
- Determine if the insurance company received gross receipts in excess of \$600,000 before the date on which it could no longer write insurance. If so, the insurance company doesn’t qualify under IRC Section 501(c)(15) for that tax year.
- Determine if the insurance company has outstanding policies on which it is liable. If not, the insurance company doesn’t qualify under IRC Section 501(c)(15).

- Determine if the insurance company's assets exceed the needs of the business. If so, determine if the company is primarily in the insurance business.
- Determine if the insurance company has received reinsurance or premiums during a tax year. If so, the insurance company wouldn't qualify under IRC Section 501(c)(15) if 50 percent or less of its gross receipts contained premiums.

Transitional Rule for Companies in Receivership or Liquidation

TRA 86 provides a transition rule for insurance companies in receivership or liquidation. It states:

- In the case of a company or association that, for the taxable year that includes April 1, 2004, meets the requirements of IRC Section 501(c)(15)(a) as in effect for the last taxable year beginning before January 1, 2004,
- And that is in a receivership, liquidation, or similar proceeding under the supervision of a State Court on April 1, 2004, the amendments made by the Act apply to taxable years beginning after the earlier of the date such proceeding ends or December 31, 2007,
- The transition rules no longer apply to the organization, even if still in receivership, liquidation or other similar proceeding under the supervision of a State Court.

Uniqueness of Exemption

An organization that wants to qualify for exemption under IRC Section 501(c)(15) may:

- Apply for exemption by filing its application on Form 1024, Application for Recognition of Exemption Under Section 501(a) or for Determination Under Section 120.
- Start filing Form 990, Return of Organization Exempt from Income Tax, without filing [Form 1024](#).

An organization that files application [Form 1024](#) and qualifies for exemption under IRC Section 501(c)(15) and the requirements in the Act, will receive a determination from the IRS. An organization that has received a determination letter from the IRS will have Status Code 01 on the INOLES and BMFOLO. This letter entitles the organization to:

- Operate as an exempt entity under IRC Section 501(c)(15) and file [Form 990](#).
- Potential relief under IRC Section 7805(b), if IRS proposes revoking the organization's tax exempt status.

Organizations that don't file the application form but do qualify for exemption under IRC Section 501(c)(15) and the requirements in the Act may also file [Forms 990](#). The difference is that they don't have a determination letter from the IRS. Organizations that file the [Forms 990](#) without a determination letter from the IRS will have Status Code 36 on INOLES and BMFOLO. Since the organization doesn't have a determination letter from the IRS:

- It wouldn't be allowed potential relief under IRC Section 7805(b) if its exempt status is ever challenged.
- We'd propose "Denial of Exemption" rather than a revocation.

Another uniqueness of organizations exempt under IRC Section 501(c)(15), whether having a determination letter from the IRS or just filing [Forms 990](#), is that they can go in and out of exemption yearly, depending on whether they meet the requirements under IRC Section 501(c)(15) and the requirements in the Act. If in one year the organization meets the requirements, it can file [Form 990](#). In another year, if it doesn't meet the requirements, it must file [Form 1120-PC](#), U.S. Property and Casualty Insurance Company Income Tax Return. An organization can switch between the two forms yearly depending if they qualify for exemption under IRC Section 501(c)(15) and the requirements in the Act.

Revocation of Exemption

An organization's exemption under IRC Section 501(c)(15) may be revoked because the organization:

- No longer qualifies as an insurance company
- Doesn't meet the requirements in IRC Section 501(c)(15) and the Act

If the organization no longer qualifies for exemption because it no longer qualifies as an insurance company, the organization must file [Forms 1120](#), U.S. Corporation Income Tax Return. If the organization was formed offshore, the organization may have to perform an unwinding procedure where the organization would file [Form 1120](#) for the first year of revocation, file [Form 1120](#) for the first day of the second year, and then file [Form 1120-F](#), U.S. Income Tax Return of a Foreign Corporation, for future years. You might require help from Small Business/Self Employed (SBSE) or Large Business & International (LB&I).

If an organization qualifies as an insurance company, but fails to meet the exemption requirements under IRC Section 501(c)(15), based on the Act requirements, it must file [Forms 1120-PC](#), U.S. Property and Casualty Insurance Company Income Tax Return.

Solicit the [Forms 1120](#) or [Forms 1120-PC](#) and establish them on AIMS Master File for agreed revocations (AIMS Non-Master File for unagreed revocations). Don't refer to SBSE or LB&I to enforce the tax.

Processing Returns After Agreed Revocation

If an IRC Section 501(c)(15) organization agrees to revocation, solicit the [Form 1120](#) or [Form 1120-PC](#). If the taxpayer can't or won't submit the return, and it must be enforced, prepare a substitute for return and establish the return on AIMS Master File, using push code 036.

If the taxpayer submits a converted return, prepare a "Converted Return Package" in a separate folder from the revocation case file. Establish the return on AIMS Master File, using push code 020.

If the converted return is incomplete or inaccurate, you may allow the taxpayer to correct and resubmit a complete and accurate return for you to process.

If the taxpayer files a disputable return that isn't fraudulent, process it, and, if the tax year meets enforcement criteria, propose an adjustment to it. If the secured return is fraudulent, consult with the TE/GE fraud specialist (TFS) or the local fraud technical advisor (FTA).

Stamp or write the date you received the return in at the upper right hand corner. Don't stamp over numbers. Annotate on the top margin or a secured converted return in red, "FORM 990 CONVERTED TO FORM 1120 BY TE/GE" or "Form 990 CONVERTED TO FORM 1041 BY TEGE." Annotate on bottom margin in red, "TC 599 cc 96."

A secured converted return copy serves as the working return for the converted return case file folder.

Attach Form 3198-A, TE/GE Special Handling Notice, to the front of the income tax return. Include a statement on penalties in the Special Instructions section of the notice.

Note: As a general rule, don't impose delinquency penalties, except under the most egregious cases in which the taxpayer failed to file [Forms 990](#) while exempt with no reasonable basis.

Submit secured converted income tax returns to the campus for processing. Before submitting, process Form 2363-A with FAST Unit to update the filing requirements and revocation. See Exhibit at the end of this guide for instructions on preparing Forms 2363-A. Fax or mail Forms 2363-A to FAST Unit using one of the following:

U.S. Postal Service:
FAST
FAST MS 1114
Ogden, UT 844040

UPS:
FAST
1st floor MS 1114
PO Box 12307 2380 Washington Blvd
Ogden, UT 84401

EFAX number: 877-814-2236
FAST e-mail address: *TEGE FAST

Monitor INOLES or BMFOLO to ensure filing requirement changes have posted to BMF. This process takes about four weeks (two cycles) to complete.

Submit Form 4844 to the FAST Unit to alert Campus noticing units of a complying taxpayer at the address above or to ESS at:

IRS
TE/GE EO Exam Special Support (ESS)
1100 Commerce Street, MC 4980DAL
Dallas, TX 75242

Prepare Secured Converted Income Tax Returns package.

Establish the secured return on AIMS Master File via RCCMS using push code 020.

If applicable, delete a previously established Non Master File record for the same return and tax year on Form 10904.

Send the original converted return package to Ogden Campus by Form 3210, using procedures similar to delinquent returns.

Submit the case to EO Mandatory Review.

Preparation of Secured Converted Income Tax Returns Package

Prepare the Converted Return Package which will contain the original converted returns filed with you. Send the package with Form 3210 to Campus after processing Forms 2363-A and 4844. Also, include a completed Form 3198-A:

- Check the box for “Send all communications per Power of Attorney,” if applicable.
- In Other Instructions, write “CONVERTED FORM (1120 OR 1120-PC or 1041) RETURN SECURED BY TE/GE – EXEMPT STATUS REVOKED.”
- In Special Instructions, write in big bold letters, “THE ASSESSMENT STATUTE EXPIRATION DATE (ASED) OF ATTACHED FORM (1120 OR 1120-PC OR 1041) STARTS WITH THE FILING OF FORM 990 ON (date 990 was filed) AND EXPIRES (state expiration date of Form 990).”
- In Other Instructions if applicable, write “NOTIFICATION OF STATE OFFICIALS – SECTION 6103(d).”
- Write on the Form 3198 “ASSESS THE FAILURE TO FILE AND/OR FAILURE TO PAY PENALTY” or “DO NOT ASSESS THE FAILURE TO FILE AND/OR FAILURE TO PAY PENALTY OR OTHER PENALTIES – REASONABLE CAUSE ESTABLISHED.”
- In Other Instructions (agreed and default cases only), write, “TRANSFER CREDIT FOR TAX PAID ON (YYYYMM) FORM 990-T TAX MODULE TO THIS CONVERTED RETURN MODULE.”

Attach a Form 3198-A to each Converted Return.

If we receive payment, follow these steps:

1. Prepare a Form 3244-A, Payment Posting Document, for each taxable year that payment was received. Enter the amount of the total payment opposite Code 670 and enter a zero opposite Code 570. The TC 570 prevents the payment from refunding until the examination deficiency has posted.
2. Make a copy(s) of the Form(s) 3244-A and the check or other payment document, such as a money order you received for the income tax case file. Enter "Copy – Original sent to the Ogden Campus on (Date)" on the top of the copy(s) of Form(s) 3244-A in "red."
3. For amounts under \$100,000 mail the Form 3244-A and payment to:
IRS
1973 N. Rulon White Blvd.
Ogden, Utah 84404
4. For amounts over \$100,000 mail the Form 3244-A and payment to:
IRS
1973 N. Rulon White Blvd.
Mail Stop 2003
Ogden, Utah 84404
5. Prepare Form 3210, Document Transmittal, to transmit the payment to Campus. Itemize each payment on Form 3210.

Annotate "Original Secure Income Tax Return" in red at top margin, "FORM 990 CONVERTED TO FORM 1120 BY TE/GE ON (Date)." Annotate in red at bottom margin, "TC 599 cc 96."

If applicable, submit a copy of power of attorney, and a copy of executed consent to extend the statute of limitations. The copy of the executed consent is the last document facing the rear.

Submit current transcript, BMFOLT/TXMODA and INOLES/BMFOLO, used to determine the organization's failure to file a required return. The transcript must not be more than 30 days old.

A copy of the entire package serves as a working return for the income tax return case file. Properly annotate it in red on the top margin as "Copy of" immediately before the original annotation.

Submit the revocation and converted return file to EO Mandatory Review for final processing.

Processing Returns After Unagreed Revocation, Without Protest

If after issuing a 30 day proposed revocation letter and the taxpayer doesn't respond (default), you must send the file to Mandatory Review for further processing. If enforcement of income taxes is required, prepare a substitute for converted returns and place them in a separate income tax file to be closed with the revocation file. Establish the substitute for converted returns on AIMS Master File, using push code 036. Submit both files to Mandatory Review for further processing.

The revocation case file contains:

- Form 3198. See Exhibit 3 at the end of this guide for how to complete.
- Form 5599, Disposal Code (DC10) (RCCMS 604). See Exhibit 2 at the end of this guide for how to complete.
- A copy of the 30 day letter.
- Forms 2363-A and 4844 enclosed in a sealed envelope.

The Income Tax File contains:

- Form 3198-A to attach to each substitute for Converted Return (SFCR).
- Form 5599, Disposal Code (DC10) (RCCMS 604).
- Form 4549 with computations for each tax year, including Form 13496, IRC Section 6020(b) Certification.
- Substitute for Converted Returns (dummy returns).

The “Sealed Envelope” is a “To Be Opened by Addressee Only” envelope. Label the envelope as “FORMS TO BE PROCESSED IF REVOCATION IS APPROVED.” It contains the following documents to process if Mandatory Review concurs with the revocation:

- Form 2363-A. See Exhibit 1 at the end of this guide for how to complete.
- Form 4844, to halt notices from the Campus.
- Form 5597, to open an AIMS Master File record.
- Form 10904, if applicable, to delete a duplicate AIMS Non-Master File record once you establish the AIMS Master File record.

Once completed, close the file with the revocation file to Mandatory Review for final processing.

Processing Returns After Unagreed Revocation With Protest

If the organization files a formal protest, follow these steps:

1. Prepare and place prepared Forms 2363-A and 4844 in a sealed envelope. See Exhibit 3 at the end of this procedure guide on how to complete Form 2363. A Note: The “Sealed Envelope” is a “To Be Opened by Addressee Only” envelope. Label the envelope: “FORMS TO BE PROCESSED IF REVOCATION IS APPROVED”.
2. Prepare:
 - a. Form 5599, DC 07 (RCCMS 601)
 - b. Form 3198-A
 - c. A Rebuttal Letter then issue it.
3. Close case to Mandatory Review along with revocation case for forwarding to Appeals.

Exhibit 2 – Form 5599 Instructions For Unagreed Revocation Without Protest (Default).

1	Use Disposal Code 10 (RCCMS 604), Unagreed-Without Protest
2	Use Principal Issue Code 54, Revocation. This must be the first/primary code for unagreed re- vocations
3	Place Form 5599 on outside-front of the information return case file folder, underneath Form 3198-A.

Exhibit 3 – Form 3198-A for Tax Case: Substitute for Converted Return

1	Check the Mandatory Review checkbox
2	enter“ UNAGREED INCOME TAX DEFICIENCY” next to Mandatory Review checkbox.
3	Check box for SEND ALL COMMUNICATIONS PER POA, if applicable
4	In Special Features, check SFR - Substitute for Return to be Processed box.
5	In Special Features, check“Other Instructions ”box, and indicate“SUBSTITUTE FOR RETURN PREPARED BY TE/GE – ASSESS TAX PER FORM 4549 – EXEMPT STATUS REVOKED”
6	In Other Instructions, indicate in big bold letters “ THE ASSESSMENT STATUTE EXPIRATION DATE(ASED) OF ATTACHED SUBSTITUTE RETURNS STARTS WITH THE FILING OF FORM date of Form 990”
7	In Other Instructions if applicable, indicate 30 DAY LETTER HAS BEEN ISSUED, THE TAXPAYER HAS FILED THE ENCLOSED PROTEST, AND THE CASE SHOULD BE FORWARDED TO APPEALS
8	In Other Instructions if applicable, indicate “NOTIFY STATE OFFICIALS IAW §6103(d)”
9	In Other Instructions if applicable, indicate “TRANSFER CREDIT FOR TAX PAID ON [YYYYMM] FORM 990-T TAX MODULE TO THIS SUBSTITUTE RETURN MODULE – SEE FORM 2424”
10	Prepare one Form 3198-A attached to outside-front of the converted return case file, and one attached as front page for each SFCR.