TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
TE/GE Division

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January 1, 2001

Org

Taxpayer Identification Number:

Form:
990
Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear :

We have enclosed a copy of our report of examination explaining why we believe an adjustment of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process,* explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*. We will then send you a final letter modifying or revoking exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

Internal Revenue Service
Office of the Taxpayer Advocate

ph:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Form 6018
Report of Examination
Envelope

Org – Name of Organization	State = Name of State	CPA Firm – Organization resp
Num – EIN Number	Parent of ORG = Name	XYZ – Partners of CPA Firm
Date1 – Effective Date	ABC = Affiliate Org	City, State = Name of
Date2 – Year End after Effective Date	DEF = Holding Company	City, State II- Name Other city
Subsequent Unrelated Ins Comp – Unrelated Auto Ins	Unrelated Corp Holding = name	Unaffiliated – Unrelated Corps

I. ISSUES:

A. Is ORG ("ORG"), an insurance company exempt from tax pursuant to I.R.C. § 501(c)(15) for the taxable years 20XX and 20YY ?

1. Definition of an Insurance Company

   i. ORG Earned a Substantial Amount of its Income During 20XX and 20YY from its Investment Activity

   ii. ORG Failed to Use its capital and efforts Primarily to Earn Income from its Insurance Activity

2. ORG Was Not Issuing Insurance Contracts or Reinsuring the Risks of Others During 20XX and 20YY

   i. The Policy

   ii. The Policy

B. Does ORG, a domestic captive insurance company, continue to qualify for exemption from federal income tax as an organization described in I.R.C. § 501(c)(15)?

1. "ORG" Is Not Described in Section 501(c)(15) During the Years Under Exam

2. "ORG" Cannot Rely on Its Determination Letter

3. Section 7805(b) Relief

4. Effective Date If § 7805(b) Relief Is Granted

II. FACTS:

A. "ORG" 's Income Statement

"ORG" reported the following on its Income Statements for the taxable years 20XX and 20YY :

	20XX	20YY	Sum
Income			
Premiums Earned			
Interest On Savings			
Dividends and Interest			
Net Gain (Loss) from sale of Assets			
Total Revenue			
Percent Premium	%	%	%

B. "ORG" 's Balance Sheet

"ORG" reported the following on its Balance Sheets for the taxable years 20XX and 20YY :

	20XX	20YY
Assets:		
Cash-Checking		
Savings Receivable		
Investments - Other		
Accrued		

Form 886-A	Department of the Treasury - Internal Revenue Service **Explanation of Items**	Schedule No. or Exhibit
Name of Taxpayer ORG EIN: Num		**Year/Period Ended** 12/31/20XX 12/31/20YY

Interest

Total

	20XX	20YY
Liabilities		
Accounts Payable		
Intercompany Payable		
Contractual Indemnity Allowance		
Common Stock Paid-in		
Paid In Capital		
Retained Earnings	)	
Total	$	$

C. "ORG" 's Form 990

"ORG" filed a Return of an Organization Exempt from Income Tax (Form 990) for the taxable years 20XX and 20YY . On its Forms 990, "ORG" reported premium income of $ in 20XX and $ for 20YY related to its I.R.C. §501(c)(15) tax-exempt status. Subsequent to 20YY , "ORG" did not claim to be or operate as a tax-exempt entity because its premium income exceeded the $ limitation described in I.R.C. Section 501(c)(15)(A).

As a result of its tax-exempt status, interest income from Savings and Temporary Cash Investments of $ in 20XX , and $ in 20YY ; dividend income of $ and capital gain income of $ for 20YY , was not subject to income tax pursuant to I.R.C. § 512(b)(1) and/or I.R.C. § 501(a).

D. <u>Organization</u>:

ORG (""ORG" ") was incorporated, under the insurance laws and the Business Corporations Act of the State of States, on Rmonth29, 20XX . The corporation was formed to "engage in the business of insuring and reinsuring various types of risk and to carry on and conduct any other lawful business or activity permitted insurance companies under States law." The corporation is under the supervisory jurisdiction of the States Department of Banking, Insurance, Securities and Health Care Administration.

"ORG" was formed as a captive insurance company to insure the risks associated with the operations of its parent and subsidiaries, and unrelated third parties. "ORG" , through a holding company ("DEF Holdings, LLC"), is a wholly owned subsidiary of Parent of Org ("Parent of Org "). In turn, Parent of Org, through its affiliates, is active in the industry in the United States. Parent of Org is located in Same state. Parent of Org affiliates include ABC. that has a facility in USA. The facility is located on or near a hazardous area, thus making its vulnerable to high risk from related loss. Other "Parent of Org" affiliates include ABC (magnetic resonance injection systems and vascular injection systems), ABC Inc. (diagnostic and products), ABC USA Company (production and protection), ABC Inc. , and Parent of Org Venture Corporation (equity investments in leading-edge technologies).

In addition, several affiliates of ORG operate fleets of company owned vehicles that are insured under various commercial insurance policies. "ORG" activities are to include providing liability coverage for the fleet of company owned vehicles.

"ORG" requested tax-exempt status under I.R.C. Section 501(c)(15) by filing Form 1024, Application for Recognition of Exemption Under Section 501(a) on Ymonth17, 20XX . In Part II, Activities and Operational Information, "ORG" described its past, present, and planned activities as follows:

> Parent of Org. is the parent corporation of ORG and a management holding company. Through its affiliates, including ABC Inc. Parent of Org is active in

the business throughout the United States.

ABC has a facility in XYZ, States, that is on or near the hazardous area, and thus faces an increased risk of related loss. This facility is insured for All Risk property damage up to its Probable Maximum Loss (PML) of $. Damage arising from an is covered only up to . Management wishes to increase this protection to cover losses of another $. ORG will therefore write a DIC policy to ABC , Inc. for $ per occurrence and in the annual aggregate coverage excess of a attachment point.

In reviewing the pricing of such coverage from various commercial markets, it has been deducted that at the attachment point the premium rating would be $ of coverage. Therefore for $ of coverage the appropriate premium would be $ per annum.

Further, several affiliates of ORG operate fleets of company owned vehicles that are insured under commercial liability policies. The protection currently purchased for these will only cover losses up to , with the potential for a multi-vehicle accident involving multiple parties that could result in losses in excess of this coverage. ORG will therefore write liability policies for each of the following entities with limits of $ per occurrence and in the annual aggregate coverage in excess of a Euro attachment point:

ORG
ABC
ABC, Inc. & Subs.
ABC, Inc.
ABC Other, Inc.

ABC, Inc.
Total vehicles

In Part II, Question 2 of the Form 1024, "ORG" indicated that its present and future support will be derived primarily from capital contributions and income from continued insurance operations.

"ORG" would be capitalized by selling shares, without par value, for a capital contribution of $ and the single interest in RELATED Holdings, LLC. No dividends would be paid by "ORG" . "ORG" had less than $ in net premiums per year, and therefore qualified as a tax-exempt insurance company pursuant to I.R.C. § 501(c)(15). A Determination Letter from the IRS was issued to "ORG" dated Qmonth 17, 20YY .

E. Implementation of the Insurance Strategy

CPA Firm maintained a database of recommended transactions (designated as the "matrix"), which were structured to produce federal income tax benefits as an important part of the intended results of the transaction. These transactions were intended to be marketed to appropriate clients of the firm. Among the transactions was one referred to as the "Corporate Gain Deferral Risk Management Strategy." The key CPA Firm partners on the project included XYZ.

The database files included a legal opinion which described the "Corporate Gain Deferral Risk Management Strategy" transaction as follows:

> ORG establishes a captive insurance company (""ORG" ") to insure risks associated with its operations as well as those of unrelated third parties. It is anticipated that ORG would form "ORG" or manage an existing captive in Year 1 such that the captive would qualify as a tax-exempt small insurance company under Section 501(c)(15). In order to meet this requirement, the captive must receive less than $ in premiums. During that year, the captive would file an application and all documentation in the captive's place of domicile to become licensed as an insurance company. In Year 1, "ORG" would contribute highly appreciated securities to the captive in a Section 351

transaction. The purpose of the contribution of the asset or assets to the captive is to provide sufficient capital for substantial insurable risks that will be transferred to the captive while it is still tax-exempt under Section 501(c)(15). The captive may dispose of the highly appreciated securities. In a subsequent year, the captive's insurance operations would expand in accordance with its business plan and the captive would become a taxable insurance company.

In discussing the need for a valid business purpose to immunize this transaction from attack by the IRS, the legal opinion cited the following reasons for entering into a captive arrangement:

1. Risk Uninsurable in conventional market.
2. Lower premium rates by the elimination of commissions and other expenses.
3. Reduced operating costs by the elimination of operating costs such as commissions, taxes, and the insurer's profits.
4. Coverage tailored to specific needs.
5. Access to global reinsurance markets.
6. Control over litigation and related services.
7. Implementation of worldwide risk management strategy.
8. Offshore placement to avoid local taxes and regulations.
9. Profit center expansion to include third party business for profit.

On Qmonth 1, 20XX, as a result of a reorganization of a combined joint venture partnership, the ORG Group owned a % interest in Foreign Corp("FC"), a Foreign corporation. Parent of ORG owned % of the % interest through ABC LLC, a single member LLC and disregarded entity. The balance (%) of the ORG Group's ownership interest in FC was owned by the Foreign parent corporation, Foreign Parent of Org. The remaining % interest of FC was owned by Unaffiliated , companies unrelated to the ORG Group.

In 19xx, the unrelated companies began a multiyear process of merging to form New Entity ., although they continued to exist as separately identified publicly listed companies during the years at issue. FC was engaged in the business of manufacturing herbicides, fungicides, environmental science, seed, and insecticide operations. The ORG Group generally did not participate in the management of FC. As of Qmonth1, 20XX, [redacted] interest in FC had a fair market value of $, and a basis of $.

The ORG Group used CPA Firm for tax return preparation and sought their tax advice on proposed transactions. On Mmonth 21, 20XX , CPA Firm provided a memorandum to DRP Tax Mgr, the Tax Director of ORG Foreign, Inc., regarding the tax consequences of the Qmonth 1, 20XX restructuring. The opinion concluded the restructuring had been accomplished on a tax-free basis.

On Mmonth 22, 20XX , the ORG's Tax Director (Tax Mgr) contacted CPA Firm regarding a "new issue" --- whether FC could once again be reorganized on a tax-free basis. Tax Mgr advised that he anticipated that FC was going to once again be recognized, this time to be combined with another global business of greater or equal value. Tax Mgr heard that Unaffiliated wanted to sell its % stake, but was not sure whether Unaffiliated B was selling as well, since, like ORG , they had to wait years to sell their interest tax-free under Foreign law. Tax Mgr inquired as to whether any scenario existed whereby the ORG Group could exchange its interests in FC for an interest in another foreign entity on a tax-free basis. The question contemplated that the reorganization would retain ORG and Unaffiliated B while a new business partner would buy out the Unaffiliated SVA shares. Tax Mgr also wanted to consider whether the domestic ownership interest could be transferred to a % owned subsidiary of ORG.

Apparently, anticipating the possibility that a sale of the ORG Group's interest in FC might be required in lieu of a reorganization, on Wmonth 1, Tax Mgr asked CPA Firm "whether any federal planning strategies have materialized that could reduce or eliminate the tax on a sale of the % interest held by the domestic group in FC." Alternatively, Tax Mgr asked CPA Firm to confirm the possibility of I.R.C. Section 351 transaction by all three shareholders, followed by Unaffiliated transferring its shares to the new buyer.

A meeting was scheduled for Wmonth 19, 20XX , to discuss the possible alternatives and present CPA Firm's recommended structure. On Wmonth 6, 20XX , in preparation for the meeting, Tax Mgr asked that CPA Firm consider a number of potential structures for transferring ABC LLC, including transfers to ORG Group affiliates ORG Venture Corporation and ORG Capital

Corporation, and transfer to a newly created Delaware holding company. Prior to 19XX, ORG had operated as the finance subsidiary for the Parent of ORG group, borrowing funds from the Foreign parent or an affiliate, and lending them to U.S. operating subsidiaries at a premium. This function shifted to Parent of ORG in 19SS. In 19TT, ORG was "revived" as a leasing company. ORG Venture Corporation was an investment company owning less than % interests in companies with products in the early stages of development, generally companies involved in ventures with Unaffiliated.

In connection with these contemplated structures, Tax Mgr noted that the proceeds from any future sale could be used to fund working capital obligations of affiliated companies. Further, as stated in an email to CPA Firm, the "preferred structure should allow for the eventual unwind of the entity retaining the % interest in FC or proceeds without significant tax consequences, i.e. the ability for a dividend to ORG which is free from any state taxes." By that point, Tax Mgr had been advised preliminary that there were no realistic federal planning strategies available, so that the alternatives presented were from a state tax perspective. Notes taken by CPA Firm state tax specialists consider the various options, but observed that the taxpayer "may have to sell right away."

A presentation was made by the state tax specialists at CPA Firm on Wmonth 19, 20XX , entitled "Planning Options for Joint Venture Interest." The presentation considered four primary options involving LLC: contribution to ORG; contribution to ORG Venture Corporation; contribution to a new Delaware holding company, and check the box. The options contemplated the eventual sale of the underlying joint venture interest in FC. The presentation included three additional options that would have improved tax savings at the state level, one of which was the creation of a captive insurance company. This structure was noted to have "additional tax savings by providing a deduction for premiums paid on terms previously self-insured."

Email communications reveal individual, after reviewing the presentations, expressed interest in a State holding company, while also considering the possibility of a captive insurance company. At the time the advisors at CPA Firm were proceeding on the assumption that they had time to consider and provide advice on the various possibilities, which they had begun to do. However, the decision was brought to a head by news that ABC had decided to sell FC to Unrelated . Individual notified CPA Firm of this event on Xmonth 5, 20XX . He suggested dropping ORG's interest into a holding company, State or otherwise, while waiting for the captive planning to materialize. On Xmonth 10, 20XX , ABC publicly announced that they would be negotiating exclusively with Unrelated for the sale of Unrelated insurance. A subsequent email sent by individual of CPA Firm on Xmonth 10, 20XX referred to this press release. In response, CPA Firm accelerated its consideration of the captive option.

The insurance group at CPA Firm provided a powerpoint presentation to individual on Xmonth 12, 20XX to provide a more detailed overview of the captive option. The powerpoint set forth both financial and tax advantages to the option. Among the financial advantages were:

- Reduced Insurance cost
- Access to reinsurance markets
- Recapture underwriting profits
- Reduce/eliminate insurance company overhead

Reduction to earnings volatility and the ability to capture investment income were also cited. Tax advantages included the deduction of premium to captive support loss reserves and the ability to defer or be exempt from taxation on captive income. Notes from the Insurance Firm state tax file indicated:

> The potential gain on the sale (of the interest) was about . Various planning options were presented as indicated in the Wmonth 19, 20XX presentation included in the file. __ of the Group acted as the manager and ran the presentation. The option ABC has decided to pursue is the Captive Insurance Co. Planning Strategy, because there would also be significant federal benefits in pursuing that strategy, under § 501(c)(15). At that point, the insurance group (Unrelated Corp) basically took over the project with respect to planning and implementation issues.

On Xmonth 13, 20XX , ______ sent ______ a pro-forma memorandum, dated Qmonth 23, 20XX , regarding the "Potential Benefits of Forming a Captive Insurance Company." The memorandum was drafted by and .

The potential benefits listed included:

1. Risk Uninsurable in Conventional Market.
2. Lower Premium Rates by the elimination of commissions and other expenses.
3. Reduced operating costs by the elimination of operating costs such as commissions, taxes, and the insurer's profits.
4. Coverage tailored to specific needs.
5. Access to global reinsurance markets.
6. cash flow
7. Control over litigation and related services.
8. Implementation of Worldwide Risk Management Strategy
9. Offshore Placement
10. Tax and other benefits.

With respect to the "cash flow" benefit, the memorandum pointed out that in a captive structure, premiums and investment income are retained with the organization's group, and the parent can also access the assets of the captive through various transfer vehicles, such as intercompany loans and the purchasing of receivables.

On Rmonth 6, 20XX , the Board of Directors of Parent of ORG issued minutes of the following determination:
The Directors find that the following facts exist in the insurance market with respect to the risks that the Company desires to have covered:

1. Premium rates for 20XX increased substantially over the rate of inflation;
2. Indications for 20YY suggest that renewal rates will increase by at least % for property, casualty, automobile and marine insurance;
3. For years subsequent to 20YY , even higher rates are anticipated due to the following: medium sized insurers will no longer be willing to underwrite industrial client business, three major reinsurers are cutting capacities and substantially increasing the prices charged to underwriters and carefully scrutinizing the risks they are willing to accept;
4. Additional capacity in property (, all-risk) and casualty (i.e. gradual pollution and products liability) will only be available via the creation of a captive insurance company.

5. In order for a captive insurance company to have sufficient capacity to provide insurance coverage for the risks faced by members of the ORG Group, the captive will need a substantial amount of capital.

On Rmonth 27, 20XX , DEF Holdings LLC ("DEF "), a limited liability entity that elected to be disregarded for tax purposes, was formed. Its sole member was ABC LLC. ABC assigned its interest in DEF to Parent of ORG on Rmonth 28, 20XX . ORG (""ORG" "), a State Corporation was formed on Rmonth 29, 20XX . Parent of ORG assigned its interest in DEF to ORG on Rmonth 29, 20XX .

On Rmonth 29, 20XX , "ORG" entered into a "Captive Services Agreement" with UNRELATED CORP Insurance Managers (USA) Inc. Under this agreement, "ORG" appointed UNRELATED CORP to be "captive manager." UNRELATED CORP 's duties included maintaining a State "home office" and "principal place of business," ensuring regulatory compliance, maintaining the corporation's books and records, assisting in the maintenance of the company's bank accounts, preparing financial, underwriting, claim, and any other typically required insurance reports, preparing state tax returns, coordinating with whomever was elected by "ORG" to provide legal, audit, actuarial, claims adjustment, loss reserve analysis and certification, and other common services, and providing administrative assistance in the implementation of any insurance or reinsurance program, including preparation of policies and contracts, billing, payment of claims, provide facilities and services to assist in the conduct of any regulatory investigations. In other words, UNRELATED CORP agreed to provide all activities pertinent to the operation of the insurance company not otherwise contracted out to accountants or other consultants.

On Tmonth 2, 20XX , a Stock Purchase Agreement was signed between Foreign (buyer) and ABC and DEF Holdings, (sellers). A separate stock purchase agreement was concurrently entered into between Foreign and the majority shareholders, Unrelated Corp and Unaffiliated (Agriculture). The ORG Stock Purchase Agreement provided for a purchase price of Euro, to be paid to ORG , and to be paid to DEF .

F. Capital Structure of "ORG"

"ORG" was capitalized with $ in cash and contributed surplus consisting of the % ownership interest in a limited liability company, DEF Holdings. DEF Holdings LLC was formed as a limited liability company pursuant to, and in accordance with, the Delaware Limited Liability Company Act, on Rmonth 27, 20XX . The sole asset held by DEF is a % minority interest in the common stock of a foreign corporation, Unrelated CorpHolding, SA. DEF reported the minority interest with a book value of $ and tax basis of $. A statement attached to the 20YY Form 990 states, "DEF Holdings LLC is a holding company that is owned % by the corporation (ORG). DEF had $ in total income and had end-of-year assets of $255,631,234. In accordance with Treasury Regs. 301-6109-1(h)(2)(i), DEF is a disregarded entity.

Unrelated Corp is closely held. No appraisal was completed in conjunction with the transfer to ORG However, based on an appraisal in Qmonth 20XX, the percent interest had a fair market value of Euro (approximately $ U.S. dollars).

G. Employees and Officers of "ORG"

Neither "ORG" nor DEF Holdings LLC had any employees during the years under audit. "ORG" did not pay a salary to its officers in 20XX and 20YY , as reflected on "ORG" 's Forms 990 for each year. It is not known whether the officers and directors of "ORG" were paid by ORG Foreign, Inc.

UNRELATED CORP Insurance Managers (USA) Inc. contracted to provide insurance management, consulting and administrative services for "ORG" . UNRELATED CORP 's duties included maintaining a State "home office" and "principal place of business," ensuring regulatory compliance, maintaining the corporation's books and records, assisting in the maintenance of the company's bank accounts, preparing financial, underwriting, claim, and any other typically required insurance reports, preparing state tax returns, coordinating with whomever was elected by "ORG" to provide legal, audit, actuarial, claims adjustment, loss reserve analysis and certification, and other common services, and providing administrative assistance in the implementation of any insurance or reinsurance program, including preparation of policies and contracts, billing, payment of claims, provide facilities and services to assist in the conduct of any regulatory investigations. In other words, UNRELATED CORP agreed to provide all activities pertinent to the operations of the insurance company not otherwise contracted out to accountants and other consultants.

H. "ORG" 's Insurance Activity for 20XX and 20YY

Prior to the establishment of DEF , Parent of ORG had an liability policy of $ per any one accident, through Subsequent Unrelated Ins Comp. In addition, it had an umbrella liability policy with Unrelated Corp 2, which provided coverage of up to $ per each occurrence, or $ aggregate. This policy provided catastrophic coverage for all risks, except for those excluded under the policy. Parent of ORG also had an insurance policy on property in City, State as described in its Form 1024, Application for Recognition of Exemption.

On Tmonth 31, 20XX , "ORG" filed a Business Plan with the State of State . The plan indicated that in the short term, the anticipated coverage was uninsured losses from a , and catastrophic accident involving multiple claimants. Because it had multi-year policies in force, it would not increase the use of the captive prior to 1/1/20YY. In the long term, management was considering the possibility of using the captive as an alternative to its current multi-year worldwide insurance program. One of the primary benefits cited was direct access to reinsurance markets, which would allow the company to obtain wholesale premium quotes, as well as lower costs of administration and profit. The Business Plan indicated the intent to confine "ORG" 's expansion program to the related group.

During the years under audit, "ORG" 's activities included providing an insurance (Policy Number: SB 20XX -02 and 20YY -02) to Unaffiliated , Inc., which is a sister company that is located in City, State. The coverage consisted of Euro per occurrence and in the aggregate coverage excess of a Euro attachment point. In reviewing the pricing of such coverage from various commercial markets, it has been deduced that at the Euro attachment point, the premium rating would be $ per million of coverage. Therefore, for $ of coverage, the appropriate premium would be $ per annum.

"ORG" also wrote an excess loss policy (Policy Number: SB 20XX -01 and 20YY -01) for car and trucks operated by several affiliated companies. The policies have limits of $ per occurrence and in the annual aggregate in excess of a Euro attachment point. At the Euro attachment point, the premium rating would be $ per vehicle. With "ORG" insuring vehicles during the years under audit, the appropriate premium would be $ per annum.[1]

"ORG" contracted with UNRELATED CORP Consultants to consider the risks, and the pricing of the risks, insured under the and catastrophic coverage policies. The study reviewed the terms of the coverage and potential loss exposure for ORG's property located in City, State . The study concluded that the probability of the captive layer attaching was significantly less than a one in a hundred years event, while the probability of the layer becoming exhausted was estimated to be significantly less. The report concluded that, given the remoteness of the loss occurrence event, the premium would normally be priced in terms of a minimum rate to cover the cost of capital and profit, rather than as a function of the risk involved. "ORG" , however, wanted to price the premium as a function of forecasted claims weighted by the relative probability of occurrence. Factoring in costs and shareholder profit, as well as investment income, the report concluded that the premium could fully fund theoretical claims in approximately XX years. This included a loading charge towards the higher end of the range traditionally used by reinsurers, and supposedly reflected ORG's conservative approach to risk funding. The premium calculated in this manner was $.

On Qmonth 14, 20XX , "ORG" issued invoice number SB to ORG and affiliates for 20YY annual premium for shock coverage under policy SB 20YY -02. The invoice was issued in care of at the .

With respect to the coverage, the report reviewed ORG's history of liability claims between 19XX and 20XX. ORG's worst liability year was 19XX, in which reported losses were less than $. Although ORG had no history of catastrophic claims, ORG "being a Foreign company, aims to project Foreign coverage standards as much as possible globally." Under Foreign law, although there was a per person limit, there was no aggregate limit on the amount of coverage. The report identified $ as an arm's length charge, but given the lower expenses of the captive, $, or a % reduction, was felt to be appropriate.

* * * *

[1] Number of vehicles insured was obtained from ORG's business plan

There was no discussion in the feasibility study of the capital needs required in order to address the risks represented by the coverage. Under the terms of the and policies, "ORG" 's maximum exposure is $.

During tax years 20XX and 20YY , "ORG" received insurance premiums from policies directly written to Parent of ORG and affiliates as follows:

Company	Vehicles	20XX Premiums	20YY Premiums
(	(Unaffiliated Lab)	$	$
Automobile:			
ORG, Inc.			
ABC Lab			
ABC			
ABC			
ABC			
ABC			
Total			

STOCK SALE

On Ymonth 23, 20XX , an article discussing the potential sale of Related Entity to Unrelated appeared in the . The articles included the following discussion about the negotiations:

> ORG, based company and minority shareholder in ABCs Unit , does not expect the sale of the ABC Unit to unrelated Parent, the Foreign group, to be finalized by the end of this month.
>
> "The sale is unlikely to be completed in Ymonth," CFO of Insurance, told . He did not know whether or not it would be completed during the first week of Tmonth, but added that the deal was certain to go ahead and was only being delayed by legal details that did not concern ORG.
>
> Unrelated Parent had said it hoped to agree terms to buy ABC by the end of the month.

> Unrelated Parent has also said it would pay between Euro and Euro for ABC Unit , including debt.
>
> ORG holds a percent stake in ABC Unit , with ABC, the life sciences group, holding the rest. With the disposal of the business, ABC and ORG are poised to become pure groups, while Unrelated parent will become the second-largest specialist in the world behind the largest organization, in company.

On Wmonth 3, 20YY , the sale of Unrelated Org was closed, and Parent Org received its % share, or $.[2] "ORG" reported the net gain on the sale of the securities on its 20YY Form 990, in the amount of $. The capital gain net income received by "ORG" was not subject to income tax due to the tax-exempt status of "ORG" .[3]

A schedule attached to the 20YY Form 990 indicated that the gain was computed as follows:

Proceeds from Sale of Investments	$
Less: Basis of Investments	( )
Investment Banking Fees	( )
Net Realized Gain	$

There is some question whether the gain was accurately computed, since "ORG" basis in the investments was only $.

ORG entered into a maximum line of credit of $ with Parent Org, on Wmonth 3, 20YY . Under the terms of the credit agreement, the line of credit is available until terminated by either party with 12 months written notice. Interest is accrued annually. As of Zmonth 31, 20YY , notes receivable outstanding totaled $.

I. Application for 501(c)(15) Exemption

On Ymonth 17, 20XX , the Service received the Form 1024,

* * * *

[2] Based on the closing, the sales price was computed to be approximately Euro

[3] ORG treated the transaction as a tax-free reorganization under IRC Section 351.

Application for Recognition of Exemption under section 501(a) along with a User Fee, from "ORG" , requesting exemption under I.R.C. Section 501(c)(15). The application was submitted by Director of Taxes with ORG. Attached to the Form 1024 application as Exhibit B was a document (2 pages) reflecting "ORG" 's response to Question 1, Part II of the Form 1024. Also attached to the Form 1024 was Exhibit G in response to Line 7, Part III. In addition, the Form 1024 attached copies of "ORG" 's Articles of Incorporation (3 pages) and Bylaws (9 pages). By letter dated Tmonth 26, 20XX , the IRS sought more information from "ORG" (2 pages). On Smonth 15, 20XX , Director of Taxes, sent a letter (1 page) to the Service confirming an extension of time until Zmonth 14, 20XX , to respond to the Tmonth 26, 20XX request. On Zmonth 31, 20XX , ORG provided its response to the Tmonth 26, 20XX , request. The request was signed by President of "ORG" . The response consisted of a two page coverletter; a copy of the Shock policy (14 pages); a copy of the policy (27 pages); a copy of the Captive Services Agreement with Related Insurance Management (USA) Inc. (7 pages); a copy of the Certificate of Formation of DEF Holdings LLC (5 pages); a copy of the Assignment and Assumption Agreement between ORG and ABC LLC (3 pages); and the Assignment and Assumption Agreement between Parent Org and "ORG" (3 pages).

On Qmonth 17, 20YY , the IRS issued a determination letter granting ORG exempt status as an organization described in section 501(c)(15) (2 pages). These documents were exchanged by the parties during the application process and comprise the administrative record that formed the basis for the determination made by the Service.

Aside from the documents identified in the above paragraphs, no other documents were exchanged during the exemption application process.

As a newly created entity, "ORG" supplied financial information for the 20XX short tax year of Rmonth 29, 20XX through Zmonth 31, 20XX , and proposed budgets for calendar years 20YY and 20YY, on its Form 1024. The applicant reported actual premium revenue of $ and investment income of $ during the 20XX short year. Also, the applicant projected premium revenues of $ for both 20YY and 20XX; investment income of $ and for 20YY and 20XX, respectively. In addition, Schedule I reports direct written premiums of $. For the 20XX short tax year, the Form

1024 application reported Net Assets of $, which included $ in cash and $ from "other investments." Exhibit G attached to the Form 1024 reflects that the other investments consist of the percent interest in DEF Holdings LLC and its sole asset, the common stock of . "ORG" reported no liabilities during the 20XX short tax year.

"ORG" filed Forms 990 for the years 20XX and 20YY . "ORG" did not report any changes in operation on Forms 990 filed with the Internal Revenue Service for the years 20XX and 20YY .

"ORG" did not submit additional documents or otherwise provide notice to the Internal Revenue Service of any changes in operations subsequent to the issuance of the Qmonth 17, 20YY , determination letter.

III. LAW AND ANALYSIS:

A. Is "ORG" an Insurance Company Exempt From Tax Pursuant to I.R.C. § 501(c)(15) for the Taxable Years 20XX and 20YY ?

The first issue is whether "ORG" is an insurance company exempt from tax pursuant to I.R.C. § 501(c)(15) for the taxable years 20XX and 20YY . I.R.C. § 501 provides that certain entities are exempt from taxation. Included in these entities are "[i]nsurance companies or associations other than life (including inter-insurers and reciprocal underwriters) if the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $." I.R.C. § 501(c)(15)(A)[4].

1. Definition of an Insurance Company.

Neither I.R.C. § 501(c)(15) nor its corresponding regulations define an "insurance company." Subchapter L of the Code (I.R.C. §§ 801-848), however, addresses the taxation of insurance companies. The term "insurance company" has the same

* * * *

[4] If an entity is a part of a consolidated group, all net written premiums (or direct written premiums) of the members of the group are aggregated to determine whether the insurance company meets the requirements of I.R.C. § 501(c)(15)(A). I.R.C. § 501(c)(15)(B). Here, although Parent Org was affiliated with the Org during 20xx and 20YY, no other members of the group sold insurance. Therefore, there are no other premiums to aggregate with the premiums ORG received during 20xx and 20YY, pursuant to I.R.C. § 501(c)(15)(B).

meaning under section 501(c)(15) as it does in Subchapter L. See H. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess. (Vol. II) 370-71, reprinted in 1986-3 (Vol.4) C.B. 370-71.

I.R.C. § 816 (formerly I.R.C. § 801) defines a life insurance company. As part of this definition, I.R.C. § 816 provides, "the term 'insurance company' means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies."

Treas. Reg. § 1.801-3(a)(1) defines an insurance company as,

> A company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

Treas. Reg. § 1.801-3(a)(1)(emphasis added). See also, Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932).

The IRS has not ruled on whether the more stringent "greater than half" test set forth in I.R.C. § 816 applies to an insurance company other than a life insurance company. Instead, to determine whether a non-life insurance company qualifies as an insurance company for tax purposes, the "primary and predominant business activity" test set forth in Treas. Reg. § 1.801-3(a)(1) applies. See Rev. Rul. 68-27, 1968-1 C.B. 315.

The courts and the IRS have also, at times, looked to whether the transaction has characteristics traditionally associated with insurance, and whether the company conducts business like an insurance company. In order for "ORG" to be considered an "insurance company" entitled to tax exempt status under I.R.C. § 501(c)(15) for the taxable years 20XX and 20YY, its primary and predominant business activity during those years must have been issuing insurance contracts or reinsuring insurance risks. See I.R.C. § 816; Treas. Reg. § 1.801-3(a)(1).

Several courts have addressed the issue of whether a company qualifies as an insurance company based on the company's primary and predominant business activity. The seminal case addressing this issue is Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932). In Bowers, the Supreme Court determined that the taxpayer was primarily engaged in "the lending of money on real-estate security, the sale of bonds and mortgages given by borrowers and use of the money received from purchasers to make additional loans similarly secured." Bowers, 285 U.S. at 188-89. Although the taxpayer in Bowers earned "premiums" that amounted to approximately one-third of its income for the taxable years at issue, these premiums were attributable to the excess of the interest paid to the taxpayer by borrowers over the amount the taxpayer paid the purchasers to whom it subsequently sold bonds and mortgages. Id. at 188 n.5. The premiums also included fees the taxpayer charged for guaranteeing mortgage loans which it did not make or sell. Id. at 186. The Court noted that the "premiums" the taxpayer earned included agency and other services provided by the taxpayer which were not generally provided under traditional insurance contracts. Id. at 189.

Because the taxpayer's premium income was incidental to its business of lending money, the Bowers Court held that the taxpayer was not an insurance company for tax purposes. Id. at 190. The Court explained, "[t]he lending fees, extension fees and accrued interest appertain to the business of lending money rather than to insurance, and may not reasonable be attributed to the subordinate element of guaranty in [taxpayer's] mortgage loan business." Id. at 189. Cf. United States v. Home Title Insurance Co., 285 U.S. 191 (1932) (holding that taxpayer was insurance company where taxpayer derived over 75% of its income from the insurance of titles and guarantees of mortgages).

In Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), the taxpayer issued and reinsured 17, 280, 325, and 424 insurance policies earning premiums totaling $867.94, $1,554.76, $1,125.70, and $1,421.98 during the taxable years 1958, 1959, 1960, and 1961, respectively. Inter-American, 56 T.C. at 507. Virtually all of the reinsurance contracts issued by the taxpayer came from another insurance company which was owned by the same two shareholders as the taxpayer. Id. Similarly, almost all of the directly written insurance policies issued by the taxpayer were issued to the same two shareholders of the taxpayer. Id. The taxpayer also engaged in the sale of real property and stock, earning investment income totaling $35,988.21, $31,195.60, $36,436.04, and $33,815.44 over the four years at issue. Id.

In Inter-American, the Tax Court compared the taxpayer's income from its insurance-related activities to its income from other activities, and held that the taxpayer was not an insurance company. According to the Tax Court, the insurance premiums the taxpayer earned were *de minimis*, comprising less than 15% of the taxpayer's gross investment income. Id. In addition, the taxpayer had no sales force in place to sell insurance contracts. Id. The Tax Court concluded that, because the taxpayer's primary and predominant source of income was from its investments, and because the taxpayer did not focus its primary and predominant efforts in pursuit of its insurance business, it was not an insurance company. Id. at 508.

The Tax Court also acknowledged that it was cognizant of the "problems indigenous to new life insurance companies, in particular, that the initial years of a new life insurance company's operations are generally difficult because the initial expenses incurred in 'putting policies on the books' are greater than the premium received" Id. (citing S. Rept. No. 291, 86th Cong., 1st Sess. (1959), 1959-2 C.B. 779). The Court explained, however, that it was basing its decision on the fact that the taxpayer did not focus its "capital and efforts primarily" on its insurance business, not on the fact that the taxpayer's insurance business was not profitable. Id. (citing Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387 (N.D. Tex. 1969).

In Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387 (N.D. Tex. 1969), rev'd on other grounds, 425 F.2d 1328 (5th Cir. 1970), the taxpayer earned no income from insurance in two of the five years under examination, and earned .66%, .87% and 9.11% of its total income from insurance during the remaining three taxable years at issue. Cardinal Life, 300 F. Supp. at 389. Instead, the taxpayer earned a majority of its income from dividends, interest, rent and capital gains. Id. Like Inter-American, the taxpayer in Cardinal Life failed to employ any brokers, solicitors, agents or salesmen. Id. It did, however, pay an actuary on a fee basis to determine the amounts of its premiums. Id. The Court noted that the taxpayer's income from insurance policies was "insignificant" compared to the total income earned by the taxpayer, explaining,

> While Plaintiff's insurance activities were insignificant, it was generating

> substantial income from dividends on stocks, rental income on real estate, rental income on trailers, interest income and capital gains upon disposal of real estate and stocks. These types of income constitute … personal holding company income which Congress has specifically stated is subject to a tax in addition to ordinary income tax. The Plaintiff is seeking to remove itself from the grasp of the personal holding company provisions by claiming life insurance company status through the issuance of a small and insignificant amount of insurance contracts.

Id. at 382.

In Industrial Life Ins. Co. v. United States, 344 F. Supp. 870 (D.S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973), the Fourth Circuit rejected the taxpayer's claim that it was an insurance company where the taxpayer earned 20% of its income from selling credit life insurance and issuing life insurance policies to its officers, and the balance of its income from its investment portfolio and the sale and leasing of real estate. The court explained,

> It is obvious from the financial information . . . that the premium income for these years was small when compared with income from real estate, mortgages and investment.
>
> It is also important to note that more than half of the premium income came from policies on the lives of the only officers and stockholders of the company.

Id. at 876. The Court likened the facts of Industrial Life to those of Cardinal Life. Id.

By contrast, in Service Life Ins. Co. v. United States, 189 F. Supp. 282 (D. Neb. 1960), aff'd on other grounds, 293 F.2d 78 (8th Cir. 1961), the Court held that the taxpayer was an insurance company where it had "over $22,000,000 worth of life insurance on its books; over 70,000 individual policies in force; and approximately $1,675,000 in premium income" over a four year period. Id. at 286. The Service Life Court acknowledged that whether a company is considered an insurance company turns on the character of the business conducted by the company, not any percentage of income. Id. at 285-86. The Court did, however, compare the taxpayer's premium income to its investment income to determine the business activity of the taxpayer. Id. at 286. Although the taxpayer also generated income from mortgage loans and investments, over half of the taxpayer's income was from its insurance premiums, and over half of its income-producing assets were held for insurance policy reserves. Id.

i. "ORG" Earned a Substantial Amount of its Income During 20XX and 20YY from its Investment Activity

Here, "ORG" should not be classified as an insurance company for tax purposes because its primary and predominant business activity during the taxable years 20XX and 20YY was its investment and lending activities, not its insurance activity. This is evidenced by the sources of "ORG" 's income during the years at issue. "ORG" reported the following income on its Forms 990 for the taxable years 20XX and 20YY :

	20XX	20YY	Total
Program Service Revenue[5] (Line 2)	$	$	$
Interest on Savings and temporary cash investments (Line 4)			
Dividends and interest from Securities			
Other investment income - Sale of Assets(Line 8d)			

* * * *

[5] This "program service revenue" is the premium income generated from ORG's insurance contracts with Parent Org and its affiliates.

Total Revenue(Line)	$	$	$

The majority of "ORG" 's income during 20XX and 20YY was attributable to "ORG" 's investment activity. "ORG" was created in mid-20XX , and did not generate substantial investment income during that year. Although the % interest of ABC Holdings LLC had been transferred to "ORG" , in 20XX , the substantial capital gain net income was realized from the subsequent sale of the ABC Related common shares owned by "ORG" , through its ownership interest in ORG Holdings LLC. Based on the financial information reported on the Form 990 returns filed by "ORG" for years 20XX and 20YY , "ORG" earned less than percent of its combined total revenue from insurance premiums (See page 2 of this report).

ii. "ORG" Failed to Use its Capital and Efforts Primarily to Earn Income from its Insurance Activity.

In addition to focusing on the sources of a company's income to determine if the company qualifies as an insurance company for tax purposes, courts have also considered the manner in which the company conducts its business activities. A taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Cardinal Life, 300 F. Supp. at 391.

During 20XX and 20YY , "ORG" purported to operate as an insurance company, providing shock and accident insurance coverage to ORG and its domestic affiliates. Based on the following, however, "ORG" has failed to demonstrate that it concentrated its capital and efforts primarily on its insurance business because "ORG" was extremely overcapitalized.

Under the investment strategy introduced by CPA Firm, the highly appreciated stock was contributed to "ORG" for the purpose of providing sufficient capital for substantial insurable risks that will be transferred to the captive while it is still tax-exempt under Section 501(c)(15). In addition, CPA Firm also advised the Tax Director that the captive may dispose of the highly appreciated securities. In a subsequent year, the captive's insurance operations would expand in accordance with its business plan and the captive would become a taxable insurance company.

"ORG" maintained a capital surplus of $ as of Zmonth 31, 20XX , and a $ surplus as of Zmonth 31, 20YY . The 20YY surplus was generated from the sale of the appreciated stock held by "ORG" , which produced a net gain of $. The surpluses were supposedly maintained to cover insurable risk transferred to "ORG" . These surpluses were maintained by "ORG" (insurer) even though ORG and affiliates (insured) already had an insurance plan providing for catastrophic coverage of $ per occurrence (or $ aggregate) under the umbrella policy with Unrelated Corp 2 and through Subsequent Unrelated Ins Comp ( ). The purpose of the captive was to provide and coverage in addition to the coverage already held by ORG. "ORG" was to provide additional coverage of $ above the Euro $ attachment point, and an additional $ of coverage above the Euro $ attachment point.

The likelihood of "ORG" sustaining a catastrophic or accident losses was very remote. Based on its own feasibility study, it was concluded that the likelihood or probability of a catastrophic loss in excess of Euro was between and percent within the period of 250 to 500 years. Also, the catastrophic coverage provided through Subsequent Unrelated Ins Comp and Unrelated Corp 2 covered losses up to Euro $ only. The coverage provided by "ORG" did not start until losses exceeded the Euro $ attachment point. Therefore, ORG and affiliates were unprotected for potential losses exceeding Euro $ and less than Euro $.

Therefore, under the terms of the and policies executed by ORG and affiliates with "ORG" , the maximum loss or combined limit of liability for "ORG" is $ for 20YY . Based on the level of risks under the policies, and the remoteness of catastrophic losses, "ORG" did not need a $ surplus to fund the $ in exposure.

Tax Year	Premiums	Net Assets	Ratio
20XX	$	$	1:166
20YY			1:692

Relying on the rationale in Bowers, some investment income is undoubtedly required to support a company's insurance activities. See Bowers, 285 U.S. at 189 (explaining, "'premiums' are characteristic of the business of insurance, and the creation of 'investment income' is generally, if not necessarily, essential to it."). In fact, one would expect an insurance company to have investment income attributable to investing its premiums while awaiting claims submitted by its policyholders.

The issue is how much investment income and capital is necessary for "ORG" to support the risk it assumed by entering into the insurance contracts with ORG and affiliates. As of Zmonth 31, 20XX , "ORG" held net assets of $, to cover a potential maximum risk of $, including passive investments of $. The passive investment consisted of the % interest in Unrelated Corp . However, during 20YY , and subsequent sale of the Unrelated Corpshares, the net assets of "ORG" increased from $ to $, while the maximum risk under the insurance contracts was unchanged. Even after the sale of the Unrelated Corpshare, "ORG" still owned passive investments of $, consisting of monies held in a Fund. This imbalance of investment income and assets related to the potential risk of "ORG" , suggests that "ORG" 's primary and predominant business activity during 20XX and 20YY was its investment activity, not its insurance activity.

Second, "ORG" did not incur any claims or establish loss reserves during 20YY under the catastrophic insurance policies. The absence of claims paid or incurred or reserves is further evidence that "ORG" is overcapitalized due to the unlikelihood of it sustaining catastrophic or accident losses. UNRELATED CORP Risk Services of prepared a Statement of Actuarial Opinion, for "ORG" , dated Qmonth 3, 20XX. The following opinion was expressed by UNRELATED CORP :

> Beginning Ymonth 1, 20XX ORG ("ORG") insures certain Liability and exposures for the U.S. operations of ORG , Foreign y, a global and company. For Liability, "ORG" provides USD Euro per occurrence subject to a USD annual aggregate. For , "ORG" provides

Form 886-A	Department of the Treasury - Internal Revenue Service **Explanation of Items**	Schedule No. or Exhibit
Name of Taxpayer ORG EIN: Num		**Year/Period Ended** 12/31/20XX 12/31/20YY

USD Euro per occurrence subject to a USD annual aggregate.

For these coverages, at Zmonth 31, 20YY , "ORG" has established loss and loss expense reserves of:

	Liability	
Direct loss reserves	-0-	-0-
Direct loss expense reserves	-0-	-0-
Reinsurance ceded	-0-	-0-
Net loss and loss expense reserves	-0-	-0-

In my ( ) opinion, the carried reserves shown above:

i) accepted actuarial principles and methods,
ii) are based on factors relevant to "ORG" , and
iii) make reasonable provisions for unpaid loss and loss expenses as of Zmonth 31, 20YY .

Another point supporting that "ORG" is overcapitalized is "ORG" loaned $ (through a $ maximum line of credit) to ORG on Wmonth 4, 20YY , the day after the sale of % interest in Unrelated Corp . The fact that "ORG" was in a position to immediately make such a substantial loan to ORG, clearly demonstrates that "ORG" did not intend to use such funds instaneously for its insurance operation.

Finally, during the years under audit, "ORG" did not pursue insurance or reinsurance opportunities with unrelated parties. Although "ORG" did expand its insurance operation in 20XX, the ORG Group continues to be the sole insured. "ORG" did not employ anyone to solicit its insurance business. In both Cardinal Life and Inter-American Life, where the courts determined that the primary and predominate business of each company was not insurance, neither company employed a sales force. In Cardinal Life, although the taxpayer sold some reinsurance contracts during the years at issue, the District Court noted,

> Plaintiff did not have an active sales force soliciting or selling insurance policies. Each of the insurance policies actually written by Plaintiff was as the result of reinsurance agreements wherein other companies ceded to Plaintiff certain amounts of insurance written by them. These reinsurance contracts were negotiated either by the president and sole stockholder of Plaintiff and/or the company's actuary who rendered services to Plaintiff on a fee basis. Plaintiff otherwise did not have any employees, brokers, agents or salesmen soliciting and selling insurance for it, and the only insurance written by Plaintiff was through reinsurance agreements.

Cardinal Life, 300 F. Supp. at 392. Similarly, in Inter-American Life, the Court considered the fact that the taxpayer did not "maintain an active sales staff soliciting or selling insurance policies" during the taxable years at issue as evidence of the taxpayer's "lack of concentrated effort" on the insurance business. Inter-American Life, 56 T.C. 497, 507 (1971).

Here, neither "ORG" nor DEF Holdings, LLC has any employees. The officers of "ORG" are believed to be employees of Parent of ORG "ORG" contracted with outside vendors for insurance and administrative services, actuarial services, and accounting services. However, the vendors are not responsible for soliciting insurance or reinsurance operations with unrelated third parties.

In sum, "ORG" 's primary and predominant business activity was not its insurance activity. "ORG" did not devote its capital and efforts primarily to its insurance business. During 20XX and 20YY , "ORG" did not maintain reserves to meet potential claims. "ORG" did not incur or paid any insurance claims during the years under audit. In addition, even in the opinion reached in its feasibility study, the likelihood of "ORG" incurring or paying catastrophic or accident claims is remote. "ORG" 's capital was held primarily in investments, some of which were sold and produced a substantial gain, and upon which no tax was paid. "ORG" did not employ a sales force to pursue other insurance markets. The actuarial study completed by UNRELATED CORP does not support the need for the levels of capitalization maintained by "ORG" during years 20XX and 20YY . Like Cardinal Life, "ORG" is seeking to avoid tax by claiming tax exempt small insurance company status through I.R.C. § 501(c)(15) based on its improbable and limited risks.

2. "ORG" was Not Issuing Insurance Contracts or Reinsuring the Risks of Others During 20XX and 20YY .

Neither the Internal Revenue Code nor the regulations specifically define the term insurance contract. The courts have generally required that a transaction involve both risk shifting (from the insured's perspective) and risk distribution (from the insurer's perspective) in order to be characterized as insurance. Helvering v. LeGierse, 312 U.S. 531, 539 (1941); Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 411 (3rd Cir. 1990).

Risk shifting occurs when a person facing the possibility of a loss transfers some or all of the financial consequences of the loss to the insurer. Rev. Rul. 88-72, 1988-2 C.B. 31, clarified by Rev. Rul. 89-61, 1989-1 C.B. 75. The risk transferred pursuant to an insurance contract must be a risk of economic loss. Allied Fidelity Corp. v. Commissioner, 66 T.C. 1068 (1976), aff'd., 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978).

Risk distribution refers to the operation of the statistical phenomenon known as the "the law of large numbers." When additional statistically independent risk exposure units are insured, although the potential total losses increase, there is also an increase in the predictability of average loss. This increase in the predictability of the average loss decreases the amount of the capital that an insurance company needs per risk unit to remain at a given solvency level. See Rev. Rul. 89-61, 1989-1 C.B. 75.

i. The Shock Insurance

With respect to the shock policy between "ORG" and ORG and affiliates, the government contests whether the element or characteristic of "risk distribution" is present in the policies. "ORG" entered into a single insurance agreement, policy SB 20XX -02 for 20XX and SB 20YY -02 for 20YY , with Parent of ORG and affiliates to provide $ of coverage for each and every occurrence of the peril of shock in excess of Euro $. The policy provided coverage for

Unaffiliated facilities located in City, State. This policy is consistent with the "planned" activities described in "ORG" 's Form 1024 application.

During the audit, a copy of the policy was provided in response to , dated Smonth24, 20yy. The policy submitted by "ORG" Declaration page and description of policy terms. Attached to the policy was Endorsement No. 1, which identifies the entities covered under the policy as the parent, ORG Parent, Inc., and affiliates, Unaffiliated , Inc., and other. Endorsement No.1 is signed by the Assistant Secretary of "ORG" (name is not legible), however, the document is not dated. Endorsement No. 1 appears to have been executed subsequent to "ORG" 's filing its Form 1024 application because the document served to amend and expand the "named insured" covered under the shock policy.

"ORG" received premiums of $ for 20XX , and $ for 20YY , related to coverage for Unaffiliated only. Although Endorsement No. 1 identifies the parent and its five non-insurance company affiliates as the entities covered under the shock policy, the aggregate annual premium appears to have been billed to and paid by the parent, Parent of ORG The premium income did not increase with the addition of the five named insured.

On Pmonth 1, 20YY , a wire transfer in the amount of $ was made by ORG & Unaffiliated , Inc. to pay invoice . The payment represented to aggregate annual premium for the coverage for Unaffiliated and Excess Liability insurance for the parent and its five subsidiaries. The parent and subsidiaries are not invoices separately for its respective coverage. Nor does the parent and subsidiaries remit separate premium payments to "ORG" for its respective insurance coverage. However, ORG did establish an "accounts receivable" balance due from Unaffiliated for reimbursement of the annual insurance premium.

The manner in which the arrangement between "ORG" and ORG and its subsidiaries is implemented does not satisfy the requisite "risk-distribution" required for the arrangement to constitute an insurance contract for federal income tax purposes.

> Revenue Ruling 20YY -90, 20YY -2 CB 985, Zmonth 10, 20YY , states that "a subsidiary's arrangement to provide liability insurance coverage to 12 of its parent company's

> subsidiaries constitutes insurance contracts for federal tax purposes and thus, the amounts paid as premiums by each subsidiary were deductible as business expenses. Under the arrangement, the subsidiaries were charged arm's length premiums, according to customary industry ratings, and none had liability coverage for less than 5 percent, or more than 15 percent, of the total risk insured by the subsidiary. As a result, the professional liability risk of the 12 subsidiaries was shifted to the insurer subsidiary as required to constitute an insurance contract for federal tax purposes. The common ownership of the subsidiaries, including the insurer, by the parent, did not affect the determination that the arrangements constituted insurance contracts.

In the instant case, the policy, reviewed during the audit, identifies the parent and five subsidiaries as the parties insured under the policy. However, according to the Form 1024, Application for Recognition of Exemption, only the Unaffiliated , Inc. facility is to be covered under the policy. Unaffiliated are located in City, State and lies on or near the fault. The parent and other subsidiaries are not located in State. ORG, and the affiliates are located in City, State2. Therefore, the potential for loss due the damage lies primarily with the Unaffiliated facility, and even the chance of a catastrophic loss is remote. So, in effect, "ORG" is insuring only the Unaffiliated facility. The annual premium is paid by ORG and Unaffiliated is reimbursed for the premium cost. "ORG" does not provide insurance coverage to unrelated third parties.

No court had held that a transaction between a parent and its wholly owned subsidiary satisfies the requirement of risk shifting and risk distribution if only the risks of the parent are insured. See Rev. Ruling 20YY -89. CB 984, Zmonth 10, 20YY . Also, see Stearns-Roger Corp. v. United States, 774 F.2d 414 (10^{th} Cir. 1985).

Insurance contracts are also required to include the characteristic of risk distribution. One treatise on insurance in explaining risk distribution states that, "[w]hen insurance is considered from the viewpoint of an insurer … it is appropriately viewed as a system for risk distribution as well as risk transference. Insurers deal with the uncertainty of whether a given insured will sustain a loss by combining the risks of loss for many ventures of a given type into a pool." Keeton and Widiss, Insurance Law, A Guide to Fundamental Principles, Legal Doctrines, and Commercial Practices, p. 12, West Group (1988).

The Courts have not spent a great deal of time explaining what they mean by risk distribution. No court has squarely held that there can be no risk distribution if there is only one, or a few, insureds. A fair reading of the court opinions addressing the issue, however, supports the IRS's position. See Barnes v. United States, 801 F.2d 984, 985 (7th Cir. 1986)("Risk distributing is the spreading of the risk of loss among the participants in an insurance program."). See also, Commissioner v. Treganowan, 183 F. 2d 288, 291 (2d Cir. 1950). Such spreading is effectuated by pooling among unrelated insureds. "...[R]isk distribution means that the party assuming the risk distributes his potential liability, in part, among others." Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986). Risk distribution is accomplished where the risk is distributed among insureds other than the entity that incurred the loss. See Ross v. Odom, 401 F.2d 464 (5th Cir. 1968).

The Sixth Circuit touched on the issue of risk distribution in Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989), noting there was adequate risk distribution, "where the captive insures several separate corporations within an affiliated group and losses can be spread among the several distinct corporate entities." The Ninth Circuit has also measured risk distribution by explaining, "[i]nsuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums." Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

There cannot be risk distribution when there is only one insured or significantly few insureds. During 20XX and 20YY, "ORG" failed to adequately distribute the risks associated with its shock policies. "ORG" insured only a single risk --- that of Unaffiliated , Inc., a subsidiary of Parent of ORG "ORG" did not insure risk of unrelated third parties during the years under audit. Thus, "ORG" did not maintain "numerous" or "several" independent risks in exchange for "numerous" premiums, as compared to the taxpayers in Humana and Clougherty.

ii. The Liability Insurance

In order for the arrangement between "ORG" and ORG and subsidiaries to constitute insurance contracts for federal tax purposes, both characteristics of "risk shifting" and "risk distribution" must be present. For years 20XX and 20YY , ORG already had an liability policy of $ per accident through Subsequent Unrelated Ins Comp, and additional liability coverage of $ under an umbrella policy with Unrelated Corp 2. "ORG" provided accident liability coverage in excess of that provided under the two aforementioned policies.

Based on the review of Policy Number SB 20YY -01 and 20YY -02, "ORG" provided accident insurance coverage of $ per accident in excess of Euro $. No protection or coverage was available for potential risk incurred by ORG and subsidiaries for losses exceeding $ but less than $.

The "ORG" policies identified the parent, Parent of ORG and five subsidiaries as the "named insured."

During the years under audit, "ORG" received premiums of $ for 20XX and $ for 20YY for the accident policy. The premiums were paid to "ORG" through a wire transfer made by ORG, Inc. on Pmonth 1, 20YY , for invoice Number and .

As with the shock policy, the premium for the liability coverage was invoiced to and paid by the parent entity, ORG, Inc. "ORG" did not invoice or receive premium payments separately and independently from the parent and each of its five subsidiaries.

Therefore, the manner in which the arrangement is conducted does not meet the requirement of "risk shifting" as described in Revenue Ruling 20YY -2 CB 985, Zmonth 10, 20YY .

The arrangement also lacks the characteristic of "risk distribution" because "ORG" does not receive premiums for the liability coverage from numerous independent insured, which are pooled together to minimize its risk and ability to pay claims in the event of catastrophic losses.

B. Does "ORG" , a Domestic Company, Continue to Qualify for Exemption from Federal Income Tax as an Organization Described in I.R.C. § 501(c)(15)?

Facts:

"ORG" was formed as a captive insurance company to insure the risks associated with the operations of its parent and subsidiaries, and unrelated third parties. "ORG" , through a holding company ("DEF Holdings, LLC"), is a wholly owned subsidiary of Parent of ORG ("ORG"). ORG (""ORG" ") was incorporated, under the insurance laws and the Business Corporations Act of the State of State , on Rmonth 29, 20XX . The corporation was formed to "engage in the business of insuring and reinsuring various types of risk and to carry on and conduct any other lawful business or activity permitted insurance companies under State law." The corporation is under the supervisory jurisdiction of the State Department of Banking, Insurance, Securities and Health Care Administration.

"ORG" filed an application on Form 1024 for recognition of exempt status under I.R.C. § 501(c)(15). The Form 1024 application, postmarked Ymonth 11, 20XX , was received by the Internal Revenue Service on Ymonth 17, 20XX . A Form 8718, User Fee for Exempt Organization Determination Letter Request, was also received by the Internal Revenue Service on Ymonth 11, 20XX . The application package included Articles of Incorporation for "ORG" approved by the State of State on Rmonth 29, 20XX ; Bylaws adopted by the "ORG" board of directors on Rmonth 23, 20XX ; and a Parent of ORG letter signed by Tax Mgr, Director of Taxes, dated Ymonth 11, 20XX , transmitting the Form 1024 application to the IRS.

The Form 1024 application was transferred to National Office for ruling in Ymonth 20XX .

In its application for recognition of exempt status, "ORG" represented it operated, and would operate in the future, as follows:

Parent of ORG ("Parent of ORG") is the parent corporation of ORG ("ORG Insurance") and a management holding company. Through its affiliates, including Unaffiliated , Inc. ("Unaffiliated"), ORG Foreign is active in the business throughout the United States.

Unaffiliated has a facility in City, State that is on or near the Fault, and thus faces an increased risk of related loss. This facility is insured for All Risk property damage up to its Probable Maximum Loss (PML) of $. Damage arising from an is covered only up to Euro . Management wishes to increase this protection to cover losses of another $. ORG Insurance will therefore write a Difference In Conditions ("DIC") policy to Unaffiliated , Inc. for $ per occurrence and in the annual aggregate coverage excess of a Euro attachment point.

In reviewing the pricing of such coverage from various commercial markets, it has been deducted that at the Euro attachment point the premium rating would be $ per million of coverage. Therefore for $ of coverage the appropriate premium would be $ per annum.

Further, several affiliates of ORG Foreign operate fleets of company owned vehicles that are insured under commercial liability policies. The protection currently purchased for these will only cover losses up to Euro , with the potential for a multi-vehicle accident involving multiple parties that could result in losses in excess of this coverage. ORG Insurance will therefore write liability policies for each of the following entities with limits of $ per occurrence and in the annual aggregate coverage in excess of a Euro attachment point:

ORG Foreign	cars
Unaffiliated	cars
Company, Inc. & Subs.	cars
Other, Inc.	car
Other, Inc.	cars
Misc, Inc.	truck
Total vehicles	

In Part II, Question 2 of the Form 1024, "ORG" indicated that its present and future support will be derived primarily from capital contributions and income from continued insurance operations.

"ORG" would be capitalized by selling shares, without par value, for a capital contribution of $ and the single interest in DEF Holdings, LLC. No dividends would be paid by "ORG" . "ORG" had less than $ in net premiums per year, and therefore qualified as a tax-exempt insurance company pursuant to I.R.C. § 501(c)(15). A Determination Letter from the IRS was issued to "ORG" dated Qmonth 17, 20YY .

Part III of the application, Financial Data, reflects "ORG" 's actual figures for the short tax year of Rmonth 29, 20XX through Zmonth 31, 20XX , and "proposed budgets" for 20YY and 20XX. Part III of the application shows revenue from insurance premiums in the amount of $ for 20XX (covering the period Rmonth 29, 20XX , through Zmonth 31, 20XX), with projected figures for insurance premium revenues of $ for each year 20YY and 20XX. In Schedule I, "ORG" reported direct written premiums of $ for the period of Rmonth 29, 20XX through Zmonth 31, 20XX . The amount of direct written premiums represents the aggregate of insurance premiums by members of the ORG Foreign Group. No other member of the controlled group was engaged in insurance operations. Part III reflects revenue from "ORG" 's investment income in the amount of $ for 20XX , with projected figures of $ and $ for 20YY and 20XX, respectively.

Under Part III, Assets, "ORG" lists "other investments" on line 7 of $. This asset is further identified on an attachment (Exhibit G) to the Form 1024 application as "LLC Interest." Part III of the Form 1024 also included the following footnote:

> ORG anticipates that over time, it will expand its operations to cover additional risks and entities. If it does so, premiums for such year may exceed the $350,000 limit for Section 501(c)(15) organizations. When and if such expansion will occur is uncertain, but we would not anticipate it occurring until at least 20XX.

The application was signed Ymonth 11, 20XX , by President of "ORG" . No Form 2848, Power of Attorney was submitted with the Form 1024 application. In Part I, Question 3, was listed as the contact person during the application process. The Form 1024 also included the following attachments, Exhibit B, Description of Past, Present and Planned Activities; Exhibit C, List of Officers and Directors; Exhibit D, Captive Service Agreement with UNRELATED CORP ; Exhibit E, Assignment and Assumption of Membership Agreement with ORG; Exhibit F, Schedule of "other expenses" reported in Part III; and the aforementioned Exhibit G, description of "other investments."

The Service by letter dated Tmonth 26, 20XX , requested additional information from "ORG" . It asked for a copy of the DIC policy written to Unaffiliated ; a representative copy of the liability insurance policy written with ORG and affiliates; a written confirmation that insurance policies will be issued to affiliates; a copy of the Captive Service Agreement with UNRELATED CORP Insurance Managers; a copy of the organizing document for DEF Holding LLC; and a description of "ORG" and ORG's relationship with Unrelated Corporation. The response was due within 30 days from the date of the letter.

On Smonth 15, 20XX , Tax Mgr submitted a letter to the Service confirming a telephone conversation in which the Service granted an extension of time to respond to the Tmonth 26, 20XX letter until Zmonth 14, 20XX .

In its Zmonth 13, 20XX response, "ORG" provided a copy of the Difference In Conditions ("DIC") and Liability policies issued to Parent of ORG and its affiliates; a statement confirming that the policies cover Parent of ORG and affiliates only; a copy of the Captive Service Agreement executed with UNRELATED CORP Insurance Managers; and a copy of the Certificate of Formation and Limited Liability Company Agreement for DEF Holdings LLC. "ORG" also included a description of the relationship between "ORG" and its parent and affiliates. Finally, "ORG" provided a corrected address for its insurance manager, UNRELATED CORP Insurance Managers. For the short-year ended Zmonth 31, 20XX , "ORG" reported receiving direct written premiums of $ from Parent of ORG and affiliates. On Schedule I of Form 1024, "ORG" reported direct written premiums of all members of the ORG Foreign controlled group as defined in section 831(b)(2)(B)(ii) of the Code. No other member of the ORG Foreign group is engaged in the insurance business.

The Service issued a favorable determination letter to "ORG" on Qmonth 17, 20YY . The determination letter issued to "ORG" states:

> Based on the information supplied, and assuming your operations will be as stated in your application for recognition of exemption, we have determined you are exempt from United States income tax under section 501(a) of the Code as an organization described in [section 501(c)(15)] commencing on Rmonth 29, 20XX , for tax years when your net written premiums (or, if greater, your direct written premiums) do not exceed the $350,000 limit as prescribed by this section 501(c)(15).
>
> Please notify the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service office if there is any change in your name, address, sources of support, or method of operation.

"ORG" filed Forms 990 for the tax years 20XX and 20YY . Subsequent to 20YY , "ORG" did not qualify for tax-exempt status and therefore, filed Form 1120 Corporate income tax returns. The Internal Revenue Service examined "ORG" 's Form 990 for the tax years ended Zmonth 31, 20XX and Zmonth 31, 20YY . The Internal Revenue Service also examined the consolidated Form 1120 returns of Parent of ORG and Subsidiaries, for 19ZZ, 20XX, 20XX , and 20YY .

The Form 990 for 20XX was signed by the preparer at on Smonth 13, 20YY , and by President on Smonth 15, 20YY . "ORG" completed Form 8868 requesting an extension to Rmonth 15, 20YY . The 20XX Form 990 was filed Smonth 20, 20YY . The Form 990 for 20YY was also signed by a tax preparer on Rmonth 14, 20XX, and by the President of the board, on Rmonth 15, 20xx. "ORG" requested an extension to file the 20YY Form 990 to Rmonth 15, 20xx, by filing Form 8868. The 20YY Form 990 was filed by "ORG" on Rmonth 21, 20XX.

On examination, it was determined "ORG" earned premium income of $ in 20XX and $ in 20YY , and investment income totaling $ in 20XX and $. These figures, which were reflected on Forms 990 for 20XX and 20YY , were confirmed by review of books and records.

The examination showed that "ORG" is operated to insure only the potential risk incurred by its parent, ORG, Inc. and its affiliates for the period 20XX and 20YY . "ORG" does not insure risks of unrelated third parities.

"ORG" did not advise the Internal Revenue Service of any material omissions or misstatements on its applications or any change in operations. "ORG" filed Forms 990 for each year 20XX and 20YY . Each of the Forms 990 asked the following question at line 76: "Did the organization engage in any activity not previously reported to the IRS?" On each of the Forms 990, "ORG" checked "no."

Law:

Section 501(a) of the Internal Revenue Code provides that organizations described in I.R.C. § 501(c) shall be exempt from income taxation. Section 501(c)(15) describes as exempt "insurance companies or associations other than life (including inter-insurers and reciprocal underwriters) if the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000." I.R.C. § 501(c)(15)(A). An organization is exempt under I.R.C. § 501(c)(15) only in those years in which it meets the $350,000 limitation on premium income. The premium income test includes amounts received by all entities in the exempt organization's controlled group. I.R.C. § 501(c)(15)(B) and (C).

The exempt status of an organization may be recognized by the Internal Revenue Service through the application process described in a revenue procedure issued by the Service. See, e.g., Rev. Proc. 2005-1, 2005-1 I.R.B. 1; Rev. Proc. 90-27, 1990-1 C.B. 514. Although not required to apply for a determination letter in order to claim exempt status, organizations seeking recognition of exemption from the Internal Revenue Service under

I.R.C. § 501(c)(15) may file a Form 1024, Application for Recognition of Exemption under Section 501(a).

A determination letter recognizing tax-exempt status is issued by the Internal Revenue Service to an organization where its application and supporting documents establish that it meets the requirements of the category of exemption it claims. Rev. Proc. 90-27, § 5.01, 1990-1 C.B. 514. All information by the applicant must be provided under penalties of perjury. Rev. Proc. 2005-4, § 9.13, 2005-1 I.R.B. 128. The application process ends with the issuance of a determination letter. A "determination letter" is a written statement issued by the Internal Revenue Service in response to a written inquiry by an individual or an organization that applies to the particular facts. Treas. Reg. § 601.201(a)(3).

An organization may ordinarily rely on a favorable determination letter received from the Internal Revenue Service. Treas. Reg. § 1.501(a)-1(a)(2); Rev. Proc. 2005-4, §13.01 (cross-referencing § 13.01 et seq.), 2005-1 C.B. 128. An organization may not rely on a favorable determination letter, however, if the organization omitted or misstated a material fact in its application or in supporting documents. In addition, an organization may not rely on a favorable determination if there is a material change, inconsistent with exemption, in the organization's character, purposes, or methods of operation after the determination letter is issued. Treas. Reg. § 601.201(n)(3)(ii); Rev. Proc. 90-27, § 13.02, 1990-1 C.B. 514. Any such changes must be reported to the Service so that continuing recognition of exempt status can be evaluated.

The Commissioner may revoke a favorable determination letter for good cause. Treas. Reg. § 1.501(a)-1(a)(2). A favorable determination letter may be revoked by written notice to the organization to whom the determination originally was issued. Treas. Reg. § 601.201(m) (cross-referencing Reg. § 601.201(l)); Rev. Proc. 90-27, § 14, 1990-1 C.B. 514, 518.

If the Commissioner revokes the tax-exempt status of an organization, the remaining question is whether the revocation should be applied prospectively or retroactively. Generally, revocation of a determination letter is prospective. Rev. Proc. 2005-4, § 13.04, I.R.B. 2005-1. Revocation of a determination letter may, however, be retroactive if the organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. Treas. Reg. §

601.201(n)(6)(i); Rev. Proc. 90-27, §14.01, 1990-1 C.B. 514; Rev. Proc. 2005-4, § 13.05.

In cases where the organization omitted or misstated a material fact, revocation may be retroactive to all open years under the statute. See Treas. Reg. § 601.201(l)(1). In cases where revocation is due to a material change, inconsistent with exempt status, in the character, the purpose, or the method of operation, revocation will ordinarily take effect as of the date of the material change. Treas. Reg. § 601.201(n)(6)(i); Rev. Proc. 90-27. In any event, revocation will ordinarily take effect no later than the time at which the organization received written notice that its exemption ruling or determination letter might be revoked. Treas. Reg. § 601.201(n)(6)(i).

Under certain circumstances, however, the Commissioner may, in his discretion, grant relief from retroactive revocation under I.R.C. § 7805(b) of the Code. Section 7805(b)(8) of the Internal Revenue Code provides:

> APPLICATION TO RULINGS. The Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws, shall be applied without retroactive effect. Section 301.7805-1(b) of the regulations delegates authority granted by I.R.C. § 7805(b) to the Commissioner (or the Commissioner's delegate).

An organization wishing to limit the retroactive effect of revocation must request the Commissioner, Tax Exempt and Government Entities Division, the Commissioner of Internal Revenue's delegate, exercise discretionary authority under I.R.C. § 7805(b) to limit the retroactive effect of revocation. Rev. Proc. 2005-4, § 13.09. To make such a request, the organization must follow the procedures provided in Rev. Proc. 2005-4, § 13.09(1).

To request I.R.C. § 7805(b) relief, the organization must submit a statement in support of the application of I.R.C. § 7805(b), as described in Rev. Proc. 2005-4, §13.09. See also Rev. Proc. 2005-5, § 19. The organization's statement must expressly assert that the request is being made pursuant to I.R.C. § 7805(b). The organization's statement must also indicate the relief requested and give the reasons and arguments in support of the relief requested. It must also be accompanied by any documents bearing on the request. The organization's explanation and arguments should discuss the five factors bearing on retroactivity listed in Rev. Proc. 2005-4, §13.05, as they relate to the situation at issue. These five items are, in effect, the same as the factors provided in Treas. Reg. §§ 601.201(l)(5) and 601.201(m), Statement of Procedural Rules, which states:

> Except in rare or unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling was originally issued or to a taxpayer whose tax liability was directly involved in such ruling if:
>
> (1) there has been no misstatement or omission of material facts;
> (2) the facts at the time of the transaction are not materially different from the facts on which the [determination letter] was based;
> (3) there has been no change in the applicable law;
> (4) the [determination letter] was originally issued for a proposed transaction; and
> (5) the taxpayer directly involved in the [determination letter] acted in good faith in reliance upon the [determination letter] and revoking or modifying the [determination letter] retroactively would be to the taxpayer's detriment.

If relief is granted under I.R.C. § 7805(b), the effective date of revocation of a determination letter is no later than the date on which the organization first received written notice that its exemption might be revoked. Treas. Reg. § 601.201(n)(6)(i); Virginia Education Fund v. Commissioner, 85 T.C. 743, 7522-3 (1985), aff'd 799 F. 2d 903 (4th Cir. 1986). This does not preclude the effective date of revocation being earlier than the date on which the organization first received written notice that its exemption might be revoked. Virginia Education Fund v. Commissioner, 85 T.C. at 753.

The Supreme Court has held that the Commissioner has broad discretion under I.R.C. § 7805(b) (and its predecessor) in deciding whether to revoke a ruling retroactively. Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 184 (1957). See also Dixon v. United States, 381 U.S. 68, 74-75 (1965). The Commissioner's determination is reviewable by the courts only for abuse of that discretion. Virginia Education Fund v. Commissioner, 85 T.C. 743, 752 (1985).

Analysis

1. "ORG" Is Not Described in Section 501(c)(15) During the Years Under Exam.

To be exempt from federal income tax under I.R.C. § 501(a) as an entity described in I.R.C. § 501(c)(15), the entity must be an insurance company or association, other than life (including inter-insurers and reciprocal underwriters). In addition, it must meet a premium income requirement.

A producer-owned reinsurance company (PORC) like "ORG" is an "insurance company or association" for purposes of I.R.C. § 501(c)(15) if it issues insurance contracts, distributes and transfers insurance risks, and otherwise conducts business like an insurance company. As discussed at pages 14 through 35 of this report, "ORG" did not operate in accordance with the standards recognized by the Internal Revenue Service for an insurance company and, therefore, is not an insurance company for federal income tax purposes. Because the examination of "ORG" showed it is not an "insurance company," "ORG" is not eligible to retain its exempt status under I.R.C. § 501(c)(15).

In addition, an entity described in I.R.C. § 501(c)(15) in a given year must not have net written premiums (or, if greater, direct written premiums) for that taxable year in excess of $350,000. I.R.C. § 501(c)(15). The premium income test applies to all entities in the exempt organization's controlled group. I.R.C. § 501(c)(15)(B), (C). "ORG" did not have direct written or net written premiums in excess of $350,000 during the years under audit.

Because "ORG" was not an "insurance company or association" during the years under exam, it is not exempt from federal income tax under § 501(a) as an entity described in § 501(c)(15) and revocation of the Service's recognition of exempt status is appropriate.

2. "ORG" Cannot Rely on Its Determination Letter

An organization may not rely on a favorable determination letter if the organization omitted or misstated a material fact in its application or in supporting documents. An organization also may not rely on a favorable determination if there is a material change, inconsistent with exemption, in the organization's character, purposes, or methods of operation after the determination letter is issued. Treas. Reg. § 601.201(n)(3)(ii); Rev. Proc. 2004-1, 2004-1 I.R.B. 1; Rev. Proc. 90-27, 1990-1 C.B. 514.

The conclusion that "ORG" was not an "insurance company" during the years under examination and from its inception rests primarily on an analysis of its sources of revenue and its business activities. See pages 20 through 35 of this report. In order to understand an organization's financial structure and activities and conclude that the organization is an insurance company and, therefore, entitled to be recognized as exempt, it is critical for the Service to have complete financial information and also a fair and accurate description of the organization's activities.

<u>Primary source of financial support.</u> The Form 1024 application at Part II, line 2, requires an applicant to identify its primary source of financial support. "ORG" listed capital contributions first. "ORG" made the following representations: "Financial support will be provided through capital contributions to ORG , as well as continued insurance operations.

On its Form 1024 application "ORG" represented that it was formed on Rmonth 29, 20XX . Financial information on the Form 1024 was presented for a short time frame from Rmonth 29, 20XX , through Zmonth31, 20XX . "ORG" 's representation on the Form 1024 that it had actual revenue for 20XX of $ from insurance activity and $ in investment income, for the short year period, made sense in this context and bolstered the applicant's representation that it was engaged in legitimate start-up insurance activities. The insurance premiums represented % of "ORG" 's total revenue in 20XX .

The Form 1024 application provided projected revenues for 20YY and 20XX. "ORG" projected revenues from insurance premiums in the amounts of $ for each year 20YY and 20XX.

In addition, the applicant projected investment income of $ for 20YY and $ for 20XX. Based on the proposed budgets, the insurance premiums represented % and % of "ORG" 's projected revenues for 20YY and 20XX, respectively, while the investment income was projected to constitute only % and %.

Examination of "ORG" and related entities showed the source and amount of "ORG" 's "program service revenue" did not differ significantly from representations made in the Form 1024 application. However, the investment income, received by "ORG" in 20YY , substantially exceeded the amount projected in the Form 1024 application. The chart below shows the contrast between projected program service revenue and investment income for 20YY , as reflected on the Form 1024 application, and actual revenue earned for 20YY :

	FORM 1024 PROJECTIONS	ACTUAL REVENUE FIGURES FROM 990
20YY program service revenue	$	$
investment income		
other revenue	-0-	-0-
Total	$	$

For 20XX, "ORG" projected total revenue of $, which consisted of $ of insurance premiums and investment income of $. In actuality, "ORG" did not file Form 990 for years subsequent to 20YY . For 20XX, "ORG" 's direct written premiums already exceeded the $350,000 limitation imposed under I.R.C. 501(c)(15)(A). Therefore, "ORG" did not qualify for tax-exempt status for 20XX.

The most likely explanation for the substantial discrepancy between the projected and actual figures for 20YY is the illegitimacy of the projected figures.

<u>Actual exempt function revenue: omission of material facts.</u>

1. "ORG" 's application gives the clear impression its 20XX end-of-year start-up operations were legitimate and involved a first step in pursuit of an insurance program operated by a small insurance company. In Part II of the Form 1024 application, "ORG" clearly described its primary purpose is to insure and liability risks for its parent, ORG, Inc. and its subsidiaries. As a new captive, "ORG" did not have any experience in operating an insurance program. Typically, start-up small insurance companies plan to operate as a tax-exempt entity for 5 years before expanding its operation by pursuing and insuring risks of other related or unrelated entities. Here, "ORG" operated as a tax-exempt entity for approximately 16 months (Rmonth 29, 20XX through Zmonth 31, 20YY) before expanding its business to such an extent that, for 20XX (and years thereafter), its direct written premiums exceeded the $350,000 limitation.

In Part III, Section B of the Form 1024 application, "ORG" listed the nature of its assets and liabilities as of the initial short tax year of Rmonth 29, 20XX , through Zmonth31, 20XX . "ORG" reported total assets with a book value of $ at year's end. The assets included cash of $ and "other investments" of $. No liabilities were reported. Exhibit G, attached to the Form 1024 application, identified the "other investments" as the % interest in a limited liability company, DEF Holdings LLC. The interest was contributed to "ORG" by its parent, ORG, Inc. in 20XX . The sole asset held by LLC was a % interest in Unrelated CorpHoldings . Although no appraisal was done in conjunction with transfer to "ORG" , the % interest was estimated to have a fair market value of Euro or $ U.S. dollars.

Even though "ORG" held this asset for investment purposes, it appears that "ORG" failed to include projected investment income in the proposed budgets submitted for 20YY and 20XX. Nor did "ORG" disclose, in the Form 1024 application, the plans to sale the % interest of Unrelated Corp , which were initiated by its parent, ORG, Inc., prior to the transfer of the LLC interest to DEF Holdings LLC. The Financial Times Limited, dated Ymonth 23, 20XX , included a newspaper discussion the negotiations between the shareholders of Unrelated Corp and the potential buyer. "ORG" 's parent owned a % minority stake in Unrelated

Corp .[6] The article insinuates that the sale was basically a "done-deal," although the final negotiations had yet to be completed. The article included the following statement from CFO of ORG Foreign:

> The sale is unlikely to be completed in Ymonth (20XX)," , CFO of ORG, told Financial Times Deutschland. He did not know whether or not it would be completed during the first week of Tmonth, but added that the deal was certain to go ahead and was only being delayed by legal details that did not concern ORG.

The parent, ORG , was negotiating the sale of its total interest in Unrelated Corp , while it at the same time, ORG Foreign was creating various entities to whom tax-free transfers of a portion of the Unrelated Corpshares were made. DEF Holdings LLC acquired its % interest of Unrelated Corp through a transfer from its parent, ORG Foreign, upon its formation on Rmonth 27, 20XX . Upon the formation of "ORG" , on Rmonth 29, 20XX , the parent transferred the % ownership of DEF Holdings LLC to "ORG" .

Although an article indicated that the sale of Unrelated Corp would not likely be completed by the end of Ymonth 20XX , the sellers, ORG Foreign, DEF Holdings LLC, Unrelated Corp, and purchaser, Foreign , executed a Stock Purchase Agreement, dated Tmonth 2, 20XX . The sale was not completed and finalized until on Wmonth 3, 20YY . "ORG" received proceeds of $ for its % shares in Unrelated Corp .

"ORG" filed its Form 1024 application with the Service on Ymonth 17, 20XX (postmarked Ymonth 11, 20XX), approximately three weeks before the Stock Purchase Agreement for the sale of Unrelated Corp shares was executed. Therefore, "ORG" 's shareholder and board members were fully aware of the negotiations and plan to sell "ORG's" shares of Unrelated Corp at the time the Form 1024 application was filed. None of the initial or follow up correspondence submitted by "ORG" , during the exemption application process, disclosed "ORG" 's negotiations and plan to sell the Unrelated Corp shares. If the information was adequately disclosed, the Service would have had an opportunity to determine whether "ORG" needed the proceeds

* * * *

ORG Foreign owned shares (or %) and Unrelated CorpHoldings LLC owned shares (or %).

to operation its insurance business, or whether "ORG" is overcapitalized.

"ORG" did not once come back to the Internal Revenue Service to correct its projected investment income for 20YY or 20XX. The applicant probably had a fair notion its investment income for 20YY would greatly exceed the projected investment income figure of $. The applicant had full command of the relevant facts and knew that its parent was negotiating to complete the sale of the Unrelated Corp shares. The sale would generate a substantial gain that is tax free due to "ORG" 's tax-exempt status, and the proceeds from the sale would result in "ORG" being capitalized far greater than what is needed to insure its insurance risks.

The following facts are critical to a determination of recognition of exemption under I.R.C. § 501(c)(15):

- Source of income

  (1) Primary source: "ORG" 's primary source of revenue for 20YY , was the capital gain net income from the sale of the Unrelated Corp shares, not insurance premiums.

  (2) Percentage comparison: This report at page 2 notes that "ORG" 's income from insurance premiums comprised only % of its total income for 20YY , and averaged only % of "ORG" 's total income during 20XX and 20YY , the only years that "ORG" claimed to operate as a tax-exempt entity. This percentage analysis treats "ORG" 's income of from the and liability policies as income from insurance business, although the Service contends that the contracts are not insurance.

- Use of capital and efforts

  (1) Overcapitalization: "ORG" 's parent transferred % ownership DEF Holding LLC, a holding company, to "ORG" in August 20XX . The sole asset owned by DEF was a % ownership interest in Unrelated Corp .

"ORG" sold the Unrelated Corp shares and realized capital gain net income of $. As of Zmonth 31, 20YY , "ORG" held net assets of $, while its assumed a maximum insurance risk of only $. In other words, "ORG" owned approximately $ in assets to each $ of risk under the and policies. In addition, the ratio of premiums to net assets was 1:166 for 20XX and 1:692 for 20YY . The ratios show that "ORG" is significantly overcapitalized for 20XX and 20YY .

These omissions of critical financial information affected the Service's consideration of the Form 1024 application. On its Form 1024, "ORG" also misrepresented its insurance activities.

<u>Insurance activities: material misstatements.</u>

1. In its Form 1024 application, Exhibit B, "ORG" described its "past, present and planned" activities to include providing shock insurance coverage (Policy No: SB 20XX -02 and SB 20YY -02) for Unaffiliated facilities located in City, State . Unaffiliated is an affiliate of ORG Foreign, Inc., and its main office is located in City, State2. No other properties are covered under the excess policy. This is confirmed by the description of "ORG" 's operations included in its initial business plan filed with the Department of Insurance, State of State .

The Form 1024 application reflects only one other planned activity: providing liability coverage (Policy No: 20YY -01) for Parent of ORG and its domestic affiliates. "ORG" projected insurance premiums of $ for years 20YY and 20XX, under the policies described upon-- $ for the excess policy and $.

Based on the above description of activities, "ORG" planned to provide two lines of insurance. However, the shock coverage included only one insured (Unaffiliated), and the liability policy covered its parent, Parent of ORG and its domestic affiliates.

During the examination, "ORG" provided a copy of the shock policy SB 20XX -02 (16 pages). The period covered under the policy is Ymonth 1, 20XX to Qmonth 1, 20YY . The insured covered under the policy is listed in Endorsement No. 1, which is an attachment to the 16 page policy. The insured are listed as Parent of ORG and affiliates. The affiliates include Unaffiliated related orga.

The Endorsement No. 1 (amendment) is signed by "ORG" 's Assistant Secretary. However, Endorsement No. 1 is not dated. This is relevant because the "insured" reflected in Endorsement No. 1 is not consistent with the "named insured" reflected in the Form 1024 description of past, present, and planned activities. In the Form 1024, Unaffiliated is the only named insured. Subsequent to the submission of the Form 1024 application and receipt of the exemption letter, "ORG" executed Endorsement No. 1 and added five additional related org named insured: Parent of ORG City, State2), . Even though five additional "named insured" were added to the policy, the premium for such coverage did not increase. The premium for the coverage provided to the initial insured, Unaffiliated was $ for 20YY and was unchanged although the number of "named insured" and risk increased.

A logical explanation for the increase in the number of "named insured" is that "ORG" directors and representatives probably realized that the coverage, as originally structured, would not constitute insurance because the arrangement lacked the element of risk distribution. With only a single insured, Unaffiliated , "ORG" is not insuring multiple parties or pooling multiple risks. The arrangement lacks the element of "risk distribution," and, therefore, is not considered insurance. Helvering v. LeGierse, 312 U.S. 531, 539 (1941); Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 411 (3rd Cir. 1990).

2. Also, in the financial information reported in Part III of the Form 1024, "ORG" included the following footnote about the future expansion of its insurance business:

> ORG anticipates that over time, it will expand its operations to cover additional risks and entities. If it does so premiums for such year may exceed the $350,000 limit for section 501(c)(15) organizations. When and if such expansion will occur is

uncertain, but we would not anticipate it occurring until as least 20XX.

The possibility of future expansion was not disclosed in Part II (or Exhibit B) of the Form 1024 application, but was buried as a footnote in the wrong section of the application.

In October 20YY , "ORG" 's board of directors approved an amendment to its business plan. Under the amended plan, "ORG" expanded its operations to include the assumption of product liability insurance for its parent, ORG, Inc. and subsidiaries, and excess reinsurance coverage on and exposures assumed from Unrelated Corp 2 . The amended business plan was approved by the State Department of Insurance in 20XX.

As detailed above, "ORG" 's Form 1024 application misrepresented relevant operational and financial data. During the application process, "ORG" misrepresented that it provided shock insurance coverage only to Unaffiliated , even though "ORG" amended its business plan to coverage five other entities in the ORG Group. If the coverage was negotiated on an arm's length basis, it is reasonable to expect that the premium income and risk from exposure would increase. Additional premiums would have jeopardized "ORG" 's qualification under I.R.C. 501(c)(15) because of the $350,000 premium income limitation. "ORG" also misrepresented that its primary source of income would be insurance premiums. "ORG" failed to divulge material facts that tended to show otherwise (i.e. the potential sale of Unrelated Corpshares). All of these facts, representations, and omissions were, in our view, material to the ruling on the application and go to the essence of the issues raised on examination.

ORG implemented an insurance strategy that was designed to minimize the state and federal income tax consequences resulting from the sale of the Unrelated Corp interest. That strategy included the formation of a captive insurance company. ORG's Tax Director, Tax Mgr, worked closely with representatives from CPA Firm to discuss the state and federal tax advantages in forming a captive insurance company. The decision to form the captive insurance company became more apparent after Agriculture announced, in Xmonth 20XX , that it would sell Unrelated Corp to Org Foreign. CPA Firm identified the tax advantages of forming the captive as (1) the deduction of premium paid to the captive to support loss reserves, and (2) the ability to defer or be exempt from taxation on captive income. CPA Firm state tax file included the following analysis:

> The option Unaffiliated has decided to pursue is the Captive Insurance Co. Planning Strategy, because there would also be significant federal benefits in pursuing that strategy, under § 501(c)(15).

In connection with the application of IRC § 7805(b) relief, the applicant may argue the projections, omissions and misrepresentations at issue are not part of the retroactivity equation. Presumably, however, the IRS gives weight to financial projections and operations (actual and planned) during the application process. If so, the IRS presumably insists and requires the applicant disclose all known and relevant financial and operational information at the application stage to permit fair consideration of an applicant organization.

Materiality analysis. Facts (listed below) developed on examination that were not provided by "ORG" on its Form 1024 application:

- The 20XX plan and negotiations to sell the ORG Group interest (including "ORG" 's holdings) in Unrelated Corp .
- "ORG" 's decision to expand the "named insured" covered by the shock policy from only Unaffiliated , to include the parent and four additional affiliates.

In summary, we think the availability of this factual information would likely have prompted the Exempt Organizations Division to conclude "ORG" was set up as an investment company, not an insurance company. Accordingly, in our view, "ORG" may not rely on its favorable determination letter.

3. Section 7805(b) Relief

While revocation of a determination letter is generally not retroactive, revocation of a determination letter may be retroactive if the organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. Treas. Reg. § 601.201(n)(6)(i). See also, Rev. Proc. 2005-1, 2005-1 I.R.B. 1; Rev. Proc. 90-27,

§14.01 (cross-referencing § 13.01 et seq.), 1990-1 C.B. 514. In cases where the organization omitted or misstated a material fact, revocation may be retroactive to all open years under the statute. See Treas. Reg. § 601.201(l)(1). In cases where revocation is due to a material change, inconsistent with exempt status, in the character, the purpose, or the method of operation, revocation will ordinarily take effect as of the date of the material change. Treas. Reg. § 601.201(n)(6)(i); Rev. Proc. 90-27, 1990-1 C.B. 514. In any event, revocation will ordinarily take effect no later than the time at which the organization received written notice that its exemption ruling or determination letter might be revoked. Treas. Reg. § 601.201(n)(6)(i).

In this case, the agent recommends retroactive revocation of the determination letter because there were omissions and misstatements of material fact during the application process and also a material change in operation. Accordingly, it is recommended that revocation be effective as of Rmonth 29, 20XX , the date of inception, as identified in "ORG" 's determination letter.

Upon request by "ORG" , the Division Commissioner (TE/GE) may, in his/her discretion, grant relief from retroactive revocation under I.R.C. § 7805(b)(8) of the Code. Should "ORG" make a request for relief from retroactive revocation, following the procedures under Rev. Proc. 2005-4, I.R.B. 2005-1, (which cross references Rev. Proc. 2005-5), the Commissioner is urged to deny such relief.

In requesting relief under I.R.C. § 7805(b)(8), "ORG" would need to address each of the following factors:

(1) there has been no misstatement or omission of material facts;
(2) the facts subsequently developed are not materially different from the facts on which the ruling was based;
(3) there has been no change in the applicable law;
(4) the ruling was originally issued with respect to a prospective or proposed transaction; and
(5) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment.

Treas. Reg. § 601.201(l)(5), Statement of Procedural Rules. See also, Rev. Proc. 2005-5, 2005-1; Rev. Proc. 96-4, § 12, 1996-1 I.R.B. 94; Rev. Proc. 90-27, § 14, 1990-1 C.B. 514, 518.

As discussed in detail above, the facts show "ORG" omitted and misstated facts on its Form 1024 application during the application process and operated materially differently from what had been represented. Because "ORG" misstated and omitted material facts and because those facts when developed were materially different from those upon which the exemption ruling was based, it is not appropriate for the Commissioner to grant relief from retroactive revocation of "ORG" 's determination letter. In addition, "ORG" does not meet any of the remaining three factors 3 through 5. The proposed revocation is not due to a change in the applicable tax law subsequent to "ORG" receiving tax-exempt status. Nor is the adverse action based on proposed transactions or activities of "ORG" . By omitting or misstating material facts, during the application process, "ORG" did not act in good faith and thus, cannot rely on its ruling letter.

4. Effective Date If § 7805(b) Relief Is Granted

If the Commissioner grants relief to "ORG" under I.R.C. § 7805(b), the effective date for revocation of "ORG" 's determination letter should be not later than the date on which the organization first received written notice that its exemption might be revoked. Treas. Reg. § 601.201(n)(6)(i); Virginia Education Fund v. Commissioner, 85 T.C. 743, 752-3 (1985), aff'd 799 F. 2d 903 (4th Cir. 1986). This does not preclude the effective date of revocation being earlier than the date on which the organization first received written notice that its exemption might be revoked. Virginia Education Fund v. Commissioner, 85 T.C. at 753.

IV. TAXPAYER'S POSITION:

The taxpayer's position was presented in letters dated Smonth 00, 20AA, and Zmonth 00, 20AA by, Director of Tax, Parent of ORG In the letters, indicated that "ORG" did not wish to pursue administrative remedies within the Service, and therefore, "ORG" did not wish to file a written protest or request an Appeals Conference concerning "ORG" 's proposed revocation of tax-exempt status under IRC 501(c)(15).

V. <u>CONCLUSIONS:</u>

A. ORG, a , a domestic captive, is not an insurance company exempt from tax pursuant to Subchapter L of the Code [I.R.C. § 801-848; I.R.C. § 501(c)(15)] for the taxable years 20XX and 20YY .

B. Because ORG, , is not an insurance company, it is not exempt under I.R.C. § 501(c)(15) for the taxable years 20XX and 20YY , and thus, revocation of exempt status under I.R.C. § 501(c)(15) is proposed, effective Rmonth 00, 20XX .

C. Because ORG did not file a written protest or request an Appeals conference regarding the proposed revocation action, a final revocation letter will be issued to ORG revoking its tax-exempt status under I.R.C. 501(c)(15), effective Rmonth 00, 20XX .

LEGEND –

Org – Name of Organization
Num – EIN Number
Date1 – Effective Date
Date2 – Year End after Effective Date

UIL: 501.15-01

Taxpayer Identification Number: Num

Form: 990

Org

Tax Year(s) Ended: December 31, 20xx
Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear :

This is our final adverse determination letter as to your exempt status under I.R.C. § 501(c)(15) of the Internal Revenue Code. Our adverse determination was made because, for the year(s) of the examination, you were not operated as an "insurance company" within the meaning of I.R.C. § 501(c)(15) of the Internal Revenue Code. Your exempt status is revoked effective Date1.

We have enclosed a copy of our report of examination further explaining why we believe an adjustment of your organization's exempt status is necessary.

We have also enclosed Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues, and Publication 3498, *The Examination Process*. These publications include information on your rights as a taxpayer.

In our letter to you dated xx/xx/xx, we advised of appeals procedures and asked you to respond within 30 days in the event you wanted to take advantage of those procedures. You did not respond to that 30-day letter.

Because this case involves exemption under I.R.C. § 501(c)(15), you cannot contest the adverse determination in a declaratory judgment action under I.R.C. § 7428. You can, however, contest the revocation of exempt status in the context of any related deficiency case involving adjustments that flow from the loss of exemption. Thus, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, from any deficiency notice issued in this case or a related case after satisfying procedural and jurisdictional requirements as described in Publications 3498 and 892.

You are required to file federal income tax returns for the tax period(s) shown above, for all years still open under the statute of limitations, and for all later years. File the federal tax return for the tax period(s) shown above with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination