DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
1100 Commerce
Dallas, Texas 75242

Number: **200803022**
Release Date: 1/18/2008

October 18, 2007

UIL: 501.15-00

ORG

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 November 16, 20aa.

We have previously provided you a report of examination explaining why we believe revocation of your exempt status is necessary. We included information regarding Taxpayer Advocate, Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues, and Publication 3498, *The Examination Process*. On July 3, 20YY, you signed Form 6018-A, Consent to Proposed Action, agreeing to the revocation of your exempt status under section 501(c)(15) of the code.

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 have filed federal income tax returns for the tax period(s) shown above, and for all year ended 20XX12. 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:

IRS -Office of the Taxpayer Advocate

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

cc:

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
TE/GE Division

January 1, 2007

ORG

Taxpayer Identification Number:

Form:
990
Tax Year(s) Ended:
12/31/20XX and 12/31/20YY
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:

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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

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer ORG		Tax Identification Number EIN	Year/Period ended 12/31/20XX 12/31/20YY

LEGEND:

ORG - Name of Org	ABC - Parent Org	QRS - Affiliate State
Insure Mgmt - Name	DEF - Affiliate Org	TUV - State Parent Loc
Insure Risk - Name	GHI - Holding Company	XYZ - State of Inc
UNR - Name	JKL - Mortgage Company	Other State - Name of
BD - Board Member	MNO - Acquired Org	MHC - Mutual Holding Co
CPA- Rep	UNR - Contract Org	GC - Guarantee Company
CFO - CFO of ABC	COSTK - Comp Stock	City - Name of Any City
Off1 - Officer of Org	REL - Related Org	Actuary - Name Company
POA1 - Initial POA	A bank - Name of Bank	ACT1 - Name of actuary
FirstORG - Initial Name of Organization		EIN - TIN Number

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

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			
Total Revenue			
Percent Premium	10.01%	12.49%	11.37%

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	$	$
Cash-Savings		
Premium Receivable		
Interest Receivable		
Prepaid Insurance		
Investment/ Marketable Securities		
Total Assets	$	$

	20XX	20YY
Liabilities		
Accounts Payable	$	$
Loss Reserves		
Statutory Contingency Reserves		
Unearned Premiums		
Capital Stock		
Paid In Capital		
Retained Earnings	( )	( )
Total Liab/Asset	$	$

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 it failed to meet the new requirements for small property and casualty insurance companies imposed by Congress in the Pension Funding Equity Act of 20ZZ.

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

D. Organization:

ORG ("ORG ") was incorporated, as a captive insurance company as defined in Article 19 of Chapter 431 of the Revised Statutes, of the State of XYZ, on November 6, 20AA.

The corporation was formed to act as a stock insurer Class 2 pure captive to write the following lines of insurance, subject to approval by the Insurance Commissioner of the State of XYZ:

(a) Mortgage guarantee reinsurance, and
(b) Such other classes of insurance and reinsurance as may be authorized by law and approved by the Insurance Commissioner of the State of XYZ.

ORG was formed as a captive insurance company to reinsure and insure the risks associated with the operations of its parent, ABC and affiliate, DEF. ORG and DEF are related through a brother-sister relationship. Both entities are wholly owned by a common parent, ABC. percent of ABC voting stock is owned by a separate holding company, GHI. The remaining percent of ABC shares are publicly traded on the market. ABC and its subsidiary, DEF is located in , TUV. DEF is a mutual savings and loan association, and operates full-service branches at nine locations in TUV and QRS.

DEF completed a corporate reorganization in 20BB, creating its current mutual holding company structure of which ORG is an affiliate.[1] The reorganization allowed ABC to issue common stock, which is a source of capital not available to mutual savings banks. New capital sources were needed to support ABC's plans for expanding branch locations. ABC investments included approximately shares of COSTK stock with a fair market value $ million, and representing % of the bank's total assets.

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 May 23, 20BB. In Part II, Activities and Operational Information, ORG described its past, present, and planned activities as follows:

> ORG ("ABC") was established as an insurance subsidiary pursuant to written approval from the

[1] Prior to the 20BB reorganization, ORG was a wholly subsidiary of FirstORG, a wholly owned subsidiary of DEF.

Office of Thrift Supervision and the Federal Deposit Insurance Corporation. ORG was formed to reinsure a portion of the mortgage guaranty insurance on the residential mortgages originated or serviced by DEF, ORG 's ultimate parent. Mortgage guaranty insurance protects a lender against loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgager, i.e. the homeowner.

As a common industry practice among mortgage lenders, DEF requires that home buyers making less than a 20% down payment on the purchase of their home obtain mortgage insurance. JKL ("JKL") is the primary mortgage insurer on these loans. JKL receives the premium from the homebuyer via their mortgage payment to their mortgage service provider.

ORG has entered into a reinsurance agreement with JKL (see attached reinsurance agreement). Under the reinsurance agreement, ORG will assume 25% of the direct written premium on loans of DEF insured by JKL. JKL will retain coverage on the first 5% of the aggregate book risk of DEF's loan pool and ORG will assume all the losses on the next 5% layer. Any losses in excess of this second layer of loss coverage will be retained by JKL. The term of the reinsurance contract is for 10 years.

ORG 's initial year of operation, which did not begin until late in 20AA, provided less than $350,000 of reinsurance premium for JKL. As such, ORG is statutorily tax-exempt and is seeking recognition of such status. ORG 's insurance activities are conducted in XYZ. ORG does not intend to employ any agent or broker to provide business for ORG outside of XYZ. ORG has engaged the services of the Insure Risk, an affiliate of UNR , to act as the insurance manager.

In Part II, Question 2 of the Form 1024, ORG indicated that it was initially capitalized with a $ contribution from DEF.[2] Its present and future support will be derived primarily through continued insurance

[2] Initial capital contribution was $ for purchase of 1000 shares. DEF contributed additional capital of $ in cash.

operations. Additional capital may be contributed to ORG based upon business needs and in conformity with safety and soundness guidelines applicable to federal savings associations.

Although authorized by the Articles of Incorporation, no dividends have been paid by ORG . Upon dissolution of the corporation, any net assets will be distributed to its 100% shareholder, FirstORG ORG had less than $350,000 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 July 9, 20BB.

E. Implementation of the Insurance Strategy

DEF's insurance strategy was developed in conjunction with the corporate reorganization that took place in 20BB.

In September 19GG, the board of DEF, a federally chartered mutual savings and loan association, was in the process of finalizing a proposed reorganization into a mutual holding company structure, upon approval of its members and the Office of Thrift Supervision. The primary purpose of the reorganization was (1) to enable management to focus the thrift by removing the COSTK stock from DEF, and (2) to make the acquisition of MNO more acceptable to the Office of Thrift Supervision. The ultimate goal of the board is to move the COSTK stock to the holding company level. According to DEF board member, BD, "the primary reason for forming a mutual holding company is to normalize and focus the bank by removing the COSTK stock. Separating the stock from DEF will make it easier to run in the sense that it will enable the Board to use peer comparisons to better hold management accountable for the bank's performance. Creating the holding company and putting most of the Costk stock there will increase the association's financial and managerial flexibility."

As of March 31, 20BB, DEF owned shares of COSTK stock with a market value of $ million. The stock represented approximately % of DEF's total assets. DEF's investment in COSTK increased substantially during the 19LLs, and presented an attractive earnings growth potential. However, the sale of COSTK stock would result in substantial tax liability for DEF. Instead of liquidating the investment, DEF decided to reallocate the stock so that the stock portfolio and its retail operations could be managed more effectively. As part of the reorganization, shares of the COSTK stock was transferred out of DEF's portfolio to the newly formed ABC, MHC, MHC, and to ORG , leaving shares (%) of the stock in DEF's portfolio.

Following the reorganization, ABC (ABC) became the stock holding company for DEF. ABC holds shares of COSTK stock, previously held by DEF. MHC, a mutual holding company, owns % of the outstanding common stock of ABC, and shares of the COSTK stock received from DEF. The remaining shares (or % of portfolio) of COSTK stock would be contributed to ORG , a subsidiary of ABC.

During the period of reorganization, the board of DEF was also in discussions with CPA representatives regarding the formation of an insurance company. During the September 28, 19GG meeting, at CPA's urging, the original goal of the parties was to create the insurance company in Other State by the end of 19GG. **The premise behind setting up the insurance company is to allow DEF to get part of the premium for assuming part of the risk on the mortgage insurance the borrowers carry.** The board moved quickly to form the insurance company so DEF could capture some of the premiums during 19GG. The board of DEF expected, in a few years, the reinsurance subsidiary would make upwards of $700,000 per year.[3]

Instead of forming the insurance company in Other State, DEF filed applications to form the insurance company with the Office of Thrift Supervision and with the State of XYZ. A major reason for incorporating in XYZ instead of Other was that XYZ allowed reinsurance of Bank risk other than private mortgage insurance on 1-4 family loans. During the November 28, 20AA meeting, the board of DEF was informed that ORG had been created, and the next step is to get the insurance company funded. ORG was incorporated in the State of XYZ on November 16, 20AA, and commenced operations on November 30, 20AA. ORG was capitalized with $ cash, (check No. 1, written on November 30, 20AA. ORG is required to maintain a minimum of $250,000 in capital and surplus pursuant to the State of XYZ Insurance Division, Department of Commerce and Consumer Affairs.

The May 29, 20BB minutes included a report from BD, "we need about 400 loans in the company to make it profitable, and we think it will take about a year to get there. Except on an emergency basis, we are required to have an annual meeting in XYZ." The board was informed that the insurance company had in fact received its tax-exempt status, during the July 31, 20BB meeting.[4] Based on the reorganization plan, ORG received the remaining shares of COSTK stock from DEF on December 11,

[3]Two formal requests were made for promotional materials used in the formation of ORG. No promotional materials exist.
[4] Determination letter is dated July 9, 20BB.

20BB. On the date of contribution the stock was valued at $ per share or total FMV of $.

F. Capital Structure of ORG

ORG was initially capitalized with $ paid for 1000 shares and additional cash contribution of $, by its parent, DEF. As part of the 20BB reorganization, DEF divested a significant portion of its COSTK shares. DEF owned shares of COSTK stock valued at approximately $ as of March 31, 20BB. The shares represented % of DEF's equity. The COSTK stock was held in DEF's investment portfolio as "available for sale" under generally accepted accounting principles.

CPA completed a Prospectus, on August 10, 20BB, describing the details of the corporate reorganization and public offering of ABC common stock. The Prospectus included the following discussion:

> Our investment in COSTK stock in the 19LLs has significantly increased our capital and earnings. Because we believe that our ownership of COSTK stock continues to present attractive earnings growth potential and because the sale of COSTK stock would result in substantial tax liability for use, we have no current plans to liquidate our investment. However, we are relocating the stock so as to more effectively manage our COSTK stock investment and DEF's retail operations.
>
> In this regard, as part of the reorganization shares of the COSTK stock will be transferred out of DEF's portfolio to ABC, GHI and ORG , leaving % of our COSTK stock in DEF's portfolio.
>
> After the reorganization, ABC will hold shares of COSTK stock, while ORG and MHC each held shares. Therefore, DEF reallocated % of the COSTK shares to ORG .

In response to IDR #4, issued on November 28, 20WW , CFO of ABC, provided documentation showing that the reallocation of COSTK stock from DEF to ORG occurred on October 16, 20BB. On the date of the contribution, the shares had a fair market value of $ or $ per share.

No capital contributions were made to ORG , by ABC, subsequent to the reorganization and reallocation of COSTK stock. The shares were retained by ORG until 20ZZ, when ORG terminated and dissolved its corporate status.

G. Employees and Officers of ORG

ORG had any employees during the years under audit. ORG did not report payment of salaries and wages to employees in 20XX and 20YY. ORG is governed by a board composed of five individuals, most of whom are employees of ABC. During the audit, ORG was represented by CFO , Treasurer of ORG , and Chief Financial Officer of ABC. None of the officers of ORG receive compensation from ORG . In fact, question 75 of the 20XX and 20YY Form 990 returns asked the following question:

> Did any officer, director, trustee, or key employee receive aggregate compensation of more than $100,000 from your organization and all related organizations, of which more than $10,000 was provided by the related organizations? The return preparer indicated "no" in response to the question.

The officers are probably compensated as employees of ABC.

ORG contracted with ("UNR"), on October 1, 20AA, to provide certain management, supervision, administrative and other insurance services. The specific services are described in pages 4 through 8 of the agreement as follows:

a) UNR shall make available to ORG management, accounting, claims , loss control, finance, investment, insurance and reinsurance services; use of a business office located in XYZ; telephone, telefax and a mailing address as may be necessary for the conduct of the on-going business activities of ORG . UNR shall also provide ORG with data processing, clerical and other staff services as ORG may require.[5]
b) UNR shall handle the specific insurance risks within a given class of insurance business pursuant to ORG 's authorization.
c) UNR , after receiving specific authorization from ORG , shall cause the insurance and reinsurance policies and/or contracts of ORG to be issued, endorsed, suspended or canceled.

[5] The principal address used by ORG, in , at the time of formation is , which an affiliate of .

d) UNR shall bill, receive and render receipts for the premiums due to ORG in accordance with the terms and conditions of each policy of insurance or reinsurance contract issued.
e) UNR shall advise ORG on appropriate reserves to maintain with respect to unearned premium reserves.
f) A designated representative of UNR shall attend such shareholders and Board of Director meetings and other meetings as ORG may require.
g) ORG shall promptly comply with any and all reasonable requests for instructions which UNR may make in order to efficiently perform its duties under this Agreement.

In return for performance of the above services, ORG agreed to pay an annual fee of $ to UNR .

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

Information Document Request #2 was issued to the organization on November 28, 20WW . The IDR included worksheets prepared by the examining agent requesting statistics about the actual insurance activities conducted by ORG since its inception in November 20AA, through December 20ZZ.

In particular, the organization was requested to summarize the premium income received by source; the number of mortgage loans issued by DEF and insured by the primary insurers, JKL and REL and reinsured by ORG ; and the number of second mortgage loans issued by DEF and insured by ORG under the direct primary policy with DEF for years 20AA through 20ZZ.

The summary information was analyzed in comparison with the program descriptions reflected in the actuarial reports. It was determined that the actual operations of ORG were not nearly as extensive as that described in the actuarial reports.

Prior to the formation of ORG , the borrowers of DEF insured mortgage risk directly with third party carriers such as JKL and REL . As with most large mortgage originators, DEF intended to continue to use commercial mortgage insurance companies but to build profitability by assuming a portion of the credit risk in exchange for a portion of the insurance premium paid by the borrower.

Actuarial company completed an actuarial report for ORG dated April 20ZZ. The purpose of the report was to analyze and evaluate ORG 's claims

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/31/20XX 12/31/20YY

liability position and loss and loss adjustment expense reserve requirements from its initial year of operations through December 31, 20YY, for the excess mortgage reinsurance agreements with JKL and REL , and the second mortgage program with DEF. Exhibits 1 through 3 of the report are summarized below.

JKL

Book Year	Annual Loan Origination (a)	Average Risk (b)	Average Annual Risk Insured (c)	Risk Attachment Point (d)	ORG Attachment Point and Loss Layer (e)	Expected Loss (f)	Actual Loss (g)
20AA	$	%	$	5.0%	$	$	
20BB		%		5.0%			
20XX		%		5.0%			
20YY		%		5.0%			
	$		$		$	$	

REL

Book Year	Annual Loan Origination (a)	Average Risk (b)	Average Annual Risk Insured (c)	Risk Attachment Point (d)	ORG Attachment Point and Loss Layer (e)	Expected Loss (f)	Actual Loss (g)
20XX	$	%	$	5.0%	$	$	
20YY		%		5.0%			
	$		$		$	$	

The analysis reflects the annual loan origination amounts for each reinsurance agreement per book year. The amounts are provided by ORG 's insurance manager, UNR The analysis also reflects the 5% risk attachment point, as agreed upon by the parties in the excess mortgage reinsurance agreement, the expected and actual losses incurred by ORG for each book year. Based on the information shown in the above table, it was noted that ORG 's projected maximum risk under the reinsurance agreements is only $ (total of column e) since its inception in 20AA. The projected risk is even less when analyzing only the years under audit. ORG 's project reinsurance risk is only $ for the 20XX and 20YY tax years. The actuarial report indicates that ORG did not incur any actual losses for the book years shown in the report. This is consistent with the operations noted during the audit. ORG did not incur any losses under the reinsurance agreements executed with GC.

The Actuarial Report also reported expected losses for ORG under the Second Mortgage Program executed with DEF. The actuarial report included the following description of the program:

> ORG issued a policy to DEF, effective September 1, 20XX , to provide mortgage insurance coverage for second mortgage loans. Actual loan defaults as of

December 31, 20YY and expected loss have been reviewed in projecting loss for book years 19 through 20YY for this program as of December 31, 20YY. Expected loss is determined as a percentage of risk insured, based upon an expected loss rate of 3%; the unpaid loan balance on second mortgages in default was provided by DEF. The result of the analysis is presented in Exhibit 3 of the report, and is summarized below:

Second Mortgage Program

Book Year	Risk Insured (a)	Expected Loss Rate (b)	Ultimate Expected Loss (c)	Percent of Loss Reported (d)	Expected Reported Loss (e)	Actual Defaults (f)
19	$	3.0%	$	%	$	$
19GG		3.0%		%		
20AA		3.0%		%		
20BB		3.0%		%		
20XX		3.0%		%		
20YY		3.0%		%		
	$		$		$	$

Based on the information presented in Exhibit 3, ORG expected losses of $ for the years under audit. However, ORG did not incur any losses under the Second Mortgage Program.

The above tables are summarized from Actuarial Reports completed for ORG by Actuarial. The information reflected in the tables is provided by ORG 's insurance manager, UNR In addition to the Actuarial Reports, ORG also provided a copy of a Captive Feasibility Study, November 9, 19GG. The feasibility study was prepared by Actuary ACAS, MAAA, with CPA. The study provided a corporate overview, including a brief description of ORG 's reinsurance program, which is noted below:

> The company intends to enter into a reinsurance agreement with ("JKL"), the primary mortgage insurer. The reinsurance will be all loans originated and insured during a given policy year. The term of the contract will be for ten years. ORG will provide a layer of aggregate reinsurance with a loss attachment point that exceeds the expected losses. The reinsurance agreement requires the establishment of a trust where ORG will deposit assets to be used to pay

losses. The payment of losses under the reinsurance agreement will be limited as delineated in the reinsurance agreement.

Annual loan originations are expected to be $ per year. The average risk amount is expected to be % with an average primary premium rate of %. The reinsurance attachment point will be at a 5% loss rate up to a maximum of a 10% loss rate. This translates into a loss layer of $ per as shown in Exhibit 2. The ceded reinsurance premium will be 25% of the primary premium. These amounts and values are subject to variation, as they will depend on the volume and mix of individual loan products.

During the audit, documentation was requested from ORG to substantiate whether its actual reinsurance operations were anywhere near that described in the Actuarial Report or Feasibility Study.

ORG provided a copy of insurance billing statements for reinsurance activities conducted during 20XX and 20YY. Based on the numbers reflected in the insurance billing statements, ORG did not authorize mortgage loans anywhere near the expected $ level discussed in the feasibility study. The organization submitted a copy of its insurance billing statements as of January 1, 20YY, and January 1, 20ZZ. The statements reflected that DEF issued 70 loans totaling $ in 20XX , and 67 loans totaling $ for 20YY, which were insured by JKL. During the years under audit, none of the DEF mortgage loans were insured by REL . The following analysis uses the above origination loan information to calculate the maximum risks for 20XX and 20YY:

Book Year	Annual Loan Origination (a)	Average Risk (b)	Average Annual Risk Insured (c)	Attachment Point (d)	Attachment Point and Loss Layer (e)	Expected Loss (f)	Actual Loss (g)
20XX	$	%	$	5.0%	$	$	
20YY	$	%	$	5.0%	$	$	_

ORG 's attachment point and maximum risk under the JKL excess mortgage reinsurance agreement is $ for 20XX , and $ for 20YY (total of $). As the chart shown above demonstrates, ORG 's actual risk is substantially less than that estimated in the actuarial report. Also, the loan origination amount is nowhere near to $ level anticipated in the feasibility study. In addition, ORG does not assume any risk until after the first 5% loss layer is satisfied by the primary insurer, JKL.

When compared with the value of net assets accumulated by ORG through its existence, it is obviously clear that ORG is highly overcapitalized. During the years under audit, ORG assets were used primarily to earn investment income, as shown below:

	20XX	20YY
Net Assets	$	$
Loss Layer	$	$
Ratio	197: 1	230:1

The following schedules show the ratio of net assets to every dollar of premium and investment income received by ORG in the years under audit:

	20XX	20YY
Net Assets	$	$
Premium Income	$	$
Ratio	607: 1	402:1

	20XX	20YY
Net Assets	$	$
Investment Income	$	$
Ratio	68:1	57:1

In 20ZZ, the organization did not file Form 990. Due to a law change, ORG did not qualify as a tax-exempt entity under IRC 501(c)(15). ORG filed Form 1120-PC as a taxable property and casualty insurance company for 20ZZ.

According to the financial information reported on the Form 1120-PC for 20ZZ, ORG sold a portion of the COSTK stock and reported capital gain net income. Schedule D of the return indicated that ORG sold shares for a gross sales price of $ (or $ per share). ORG reported a net capital gain of $. ORG incurred a tax liability of $, which was offset by prior year tax deposits of $. Therefore, for 20ZZ, ORG received a refund of $ for 20ZZ. It appears that the remaining COSTK shares ( ) were distributed back to its parent, ABC.

The board of directors authorized the dissolution of ORG during a meeting held in October 20ZZ. The corporation was dissolved as of December 31, 20ZZ.

ORG filed affidavits of the corporate officers, minutes of directors and shareholders meetings and dissolution documents with the State of XYZ.

In response to IDR 6, CFO, Treasurer, provided the following information about the dissolution of ORG :

ORG was merged into its parent and all assets were passed up to ABC and all liabilities assumed by ABC as ’s successor. DEF continues to have its borrowers insure with third party carries such as __ and ___, via JKL , an industrial insured captive domiciled in Other and owned by REL .

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

On May 23, 20BB, the Service received the Form 1024, 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 Accountants, CPA’s with CPA, City, TUV office. Attached to the Form 1024 application was Statement 1, Activities and Operational Information (1 page); Statement 2, Financial Data (1 page); a copy of ORG ’s approval of its Service Corporation application to the Office of Thrift Supervision (2 pages); a copy the Notice Pursuant to Section 303.146 of the FDIC Rules and Regulations (2 pages); the JKL Excess Layer Mortgage Reinsurance contract (23 pages); a Trust Agreement identified as Exhibit B (16 pages); an Undertaking from DEF to JKL (3 pages); and CPA Statutory financial statements for short tax year 20AA (9 pages). The application also included the Articles of Incorporation (5 pages); Bylaws (13 pages); and Form 2848.

On June 12, 20BB, the Director, Exempt Organizations sent a letter advising ORG that its application was referred to National Office for ruling. The application was assigned to a Tax Law Specialist (TLS) on

June 20, 20BB. The TLS reviewed the application on June 25, 20BB, and prepared a file memo (1 page) that recommended approval of the application. The application file was closed on July 6, 20BB, without the issuance of a request for additional information from ORG .

On July 9, 20BB, the IRS issued a determination letter granting ORG exempt status as an organization described in section 501(c)(15) (3 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. The above documents are included in the administrative file maintained by the EO Records Unit in , State2. The file was received from the EO Records Units on March 5, 20ZZ. Also, an identical copy of the application file was provided by ORG .

As a newly created entity, ORG supplied financial information for the 20AA short tax year of November 16, 20AA, through December 31, 20AA, and proposed budgets for calendar years 20BB and 20XX , on its Form 1024. The applicant reported actual premium revenue of only $ and investment income of $ during the 20AA short year. Also, the applicant projected premium revenues of $ and $ for 20BB and 20XX , respectively. The applicant also reported expenses of $ for the 20AA short year. The expenses were itemized on Statement 2 attached to the application. The expenses included payment of insurance management, licensing, and legal fees. In addition to reporting the actual expenses incurred in 20AA, ORG also projected expenses of $ in the budgets proposed for 20BB and 20XX .

For the short year 20AA, ORG reported actual Net Assets of $, which consists of assets such as cash of $ and other assets of $, totaling $, and offset by liabilities of $, including accounts payable of $. Statement 2 of the Form 1024 identifies the "other" liabilities as loss reserves established in the amount of $ for 20AA.

In addition, Schedule I reports reinsurance premiums assumed of $ for the short year 20AA. The financial position of ORG as of December 31, 20AA, was supported by the CPA audited statutory statements.

ORG filed Forms 990 for the years 20AA, 20BB, 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 July 9, 20BB, 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 interinsurers 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)[6].

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 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,

[6] 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 ORG was affiliated with the ABC 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).

> 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 reasonably 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 activity, 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[7] (Line 2)	$	$	$
Interest on Savings and temporary cash investments (Line 4)			
Dividends and interest from Securities (Line 5)			
Total Revenue(Line 12)	$	$	$

The majority of ORG 's income during 20XX and 20YY was attributable to ORG 's investment activity. ORG was created in late 20AA, and generated minimal investment income during 20AA ($). As a result of a reorganization of DEF, in 20BB, ORG was the recipient of additional paid in capital in the form of shares of COSTK stock. The stock had a fair market value of $. The stock holdings generated dividend and interest income of $ in 20XX , and $ in 20YY. Based on the sources of income shown above, ORG received 88.6% of the gross income from interest and dividends. ORG earned 11.4% 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.

[7] This "program service revenue" is the premium income generated from ORG's reinsurance contracts with REL , and DEF.

During 20XX and 20YY, ORG purported to operate as an insurance company, providing excess layer reinsurance coverage on mortgage loans issued by an affiliate entity, DEF. The primary insurer for DEF mortgage loans is ("JKL") and ("REL "). The primary insurer covers the initial five percent of the aggregate book value of loans. The reinsurance provided by ORG attached only after losses exceed the initial layer covered by JKL. In addition, the reinsurance provided by ORG is limited to only the second 5% layer of losses incurred by JKL. In actuality, 100 percent of DEF's mortgage loan risk was insured by the primary insurer, JKL, however, JKL was reimbursed by ORG for five percent of the losses under the reinsurance agreement.

ORG maintained a capital surplus of $ as of December 31, 20XX , and a $ surplus as of December 31, 20YY. The surplus resulted from the contribution of COSTK shares by DEF. During 20XX and 20YY, ORG retained ownership of all COSTK shares. ORG did not sell any of the COSTK shares until 20ZZ, after it no longer qualified as a tax-exempt organization.[8] Based on the inspection of the Form 1120-PC return filed for 20ZZ, it appears that ORG sold COSTK shares, and paid tax on the gain generated from the sale. The remaining COSTK shares were distributed to its parent, ABC as part of the corporation dissolution process completed in December 20ZZ.

From its date of inception in November 20AA, through December 31, 20YY, ORG did not use its capital and efforts to actively engage in insurance operations. ORG incurred no insurance losses during this period. Nor did ORG hire any staff or have facilities to conduct an insurance operation.

During the years under audit, ORG was supposed to provide excess reinsurance for mortgage loans made by its affiliate, DEF. In order to determine whether ORG used its capital and efforts to engage in insurance or reinsurance activities, it is necessary to review the mortgage loan operations of DEF. The organization submitted a copy of its insurance billing statements as of January 1, 20YY, and January 1, 20ZZ. The statements reflected that DEF issued 70 loans totaling $ in 20XX , and 67 loans totaling $ for 20YY, which were insured by JKL. ORG 's maximum risk under the excess mortgage reinsurance agreements is $ for 20XX , and $ for 20YY.

Based on the level of risks assumed under the reinsurance agreement, ORG did not need a $ surplus to fund its exposure. ORG held

[8] For , ORG filed Form 1120-PC as a taxable property and casualty insurance company.

$197 in net assets for every $1 of risk exposure in 20XX , and $229 for every $1 of risk in 20YY.

Tax Year	Net Assets	Risk	Ratio
20XX	$	$	197:1
20YY			229:1

In addition, ORG held $607 in net assets for every $1 of premium it received in 20XX , and $402 for every $1 of premium received in 20YY.

Tax Year	Net Assets	Premiums	Ratio
20XX	$	$	607:1
20YY			402:1

While at the same time, ORG 's assets generated significant investment income. During 20XX , ORG earned $1 of investment income for every $68 of net assets it held, and in 20YY, it also earned $1 of investment income for $57 of net assets held.

Tax Year	Net Assets	Investment Income	Ratio
20XX	$	$	68:1
20YY			57:1

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 reinsurance agreement with JKL. As of December 31, 20XX and December 31, 20YY, ORG held substantial net assets to cover potential minimal insurance risks. Although ORG did not sale any of the COSTK shares during the years under audit, ORG did generate significant passive income from its holdings. The passive income represented 90% of ORG 's gross receipts in 20XX , and 88% of its gross receipts for 20YY. 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 operating as an investment holding company, not an insurance business.

Second, ORG did not incur any losses and established only minimal loss reserves to cover potential future losses. As of December 31, 20XX , ORG maintained loss reserves of $. The reserves were increased by $ in 20YY. In addition, ORG established a "contingency reserve" of $, as of December 31, 20XX , to comply with the State of XYZ, Department of Insurance law.

> The purpose of the contingency is to protect policyholders against loss during a period of extreme economic contraction. By law, insurers must set aside 50 cents of each premium dollar earned and maintain the contingency reserve for a period of ten years.

The absence of claims paid and minimal reserves is further evidence that ORG is overcapitalized due to the unlikelihood of it sustaining catastrophic mortgage loan losses.

Act1, of Actuary prepared a Statement of Actuarial Opinion, for ORG , dated May 20YY. The following opinion was expressed by Act1:

> Table 1 presents direct loss for the primary mortgage insurers as of December 31, 20XX , by book year, by company. Recognition of the Captive's attachment point and limit yields loss for which is responsible. 's loss liability under the second mortgage program is also displayed in Table 1. As can be seen in Table 1, we estimate $0 of loss (direct and assumed) for as of December 31, 20XX .

Table 1 of the Actuarial Report is recreated below:

Company	Book Year	Incurred Direct Loss	Captive Attachment Point	Captive Limit	Loss in Captive Layer
JKL	20AA	$	$	$	$
	20BB				
	20XX				
REL	20XX				
Second					

Mortgage Program	20XX
Total	

To determine the reserve needs for for liabilities associated with reinsurance assumed, we first reviewed the loss incurred by the primary mortgage insurers (separately).

As of December 31, 20XX , JKL has limited loss experience for book years 20AA, 20BB, and 20XX . We have first projected the ultimate losses for JKL (separately by book year) based upon the expected loss method. This method determines loss as a percentage of original risk insured. Based upon industry data on mortgage insurance, we have calculated expected loss as 3% of original risk insured. We then determine the expected reported to date losses by applying a reporting pattern to expected loss.

Based upon a review of the expected reported loss, as well as actual incurred loss as of December 31, 20XX , we projected that 's loss for mortgages insured by JKL is $0 for each book year.

The actuarial study completed by Actuary. does not support the need for the levels of capital 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.

In addition to establishing reserves for future losses, ORG maintained two trust accounts for the purpose of paying future losses to JKL and REL . Note 4 of the 20XX and 20YY Financial Statements prepared by CPA including the following description of the trust accounts:

In accordance with the reinsurance contract, a trust has been established pursuant to the trust agreement in order to pay losses to JKL, that arise. The trust assets are retained in the trust for the benefit of JKL. The trustee for the trust is A bank. The trust is increased periodically in order to meet contractual

> collateral requirements through premium deposits and/or capital contributions. At December 31, 20YY and 20XX , $ and $, respectively, in a money market fund was held in the trust.
>
> In accordance with the reinsurance contract, a trust has been established pursuant to the trust agreement in order to pay losses to REL , that arise. The trust assets are retained in the trust for the benefit of REL . The trustee for the trust is A bank. The trust is increased periodically in order to meet contractual collateral requirements through premium deposits and/or capital contributions. At December 31, 20YY, $, in a money market fund was held in the trust.

During the years under audit, no amounts were disbursed from the trust accounts to pay losses to JKL and REL .

Another fact supporting the lack of an insurance operation is 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).

Finally, ORG 's mortgage insurance needs were analyzed from a historical perspective. Prior to the 20BB reorganization, DEF was the only entity that existed in this structure. DEF operated since 19 , and met its mortgage insurance needs by requiring mortgagees to obtain mortgage insurance from unrelated third party insurers. This method of insuring mortgage loans is typical for the banking and lending industry. DEF used and followed standard industry practices for almost 50 years before forming ORG to meet some of the mortgage loan insurance needs. Based on the history of DEF, it appears to the motivation for forming ORG was primarily to allow DEF to share in to premium income generated from the mortgage insurance operation.

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 had small reserve balances. The rest of ORG 's capital was held in investments, which continue to grow and upon which no tax is paid. For the taxable years at issue, ORG operated primarily as a holding company (or a shell). 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 reinsurance of an insignificant amount of insurance risk.

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 reinsure and insure the risks associated with the operations of its parent and affiliate bank. ORG is a wholly owned subsidiary of ABC ("ABC"). ORG ("ORG ") was incorporated, in the State of XYZ, as a captive insurance as defined in Article 19 of Chapter 431 of the XYZ Revised Statutes, on November 6, 20AA. The corporation was formed to "write mortgage guarantee reinsurance and other classes of insurance and reinsurance as may be authorized by law and approved by the Insurance Commissioner of the State of XYZ." The corporation is under the supervisory jurisdiction of the Office of Thrift Supervision (Order No.20AA-77) and the Federal Deposit Insurance Corporation.

ORG filed an application on Form 1024 for recognition of exempt status under I.R.C. § 501(c)(15). The Form 1024 application, postmarked May 21, 20BB, was received by the Internal Revenue Service on May 23, 20BB. A Form 8718, User Fee for Exempt Organization Determination Letter Request, was also received by the Internal Revenue Service on May 23, 20BB. The application package included Articles of Incorporation for ORG approved by the State of XYZ on November 16, 20AA; and Bylaws also adopted by the ORG board of directors on November 16, 20AA.

The Form 1024 application was transferred to National Office for ruling on June 12, 20BB.

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

> ORG ("ORG ") was established as an insurance subsidiary pursuant to written approval from the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. ORG was formed to reinsure a portion of the mortgage guaranty insurance on the residential mortgages originated or serviced by DEF, ORG 's ultimate parent. Mortgage guaranty insurance protects a lender against loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgager, i.e. the homeowner.
> As a common industry practice among mortgage lenders, DEF requires that homebuyers making less than a 20% down payment on the purchase of their home obtain mortgage insurance. JKL ("JKL") is the primary mortgage insurer on these loans. JKL receives the premium from the homebuyer via their mortgage payment to their mortgage service provider.
>
> ORG has entered into a reinsurance agreement with JKL (see attached reinsurance agreement). Under the reinsurance agreement, ORG will assume 25% of the direct written premium on loans of DEF insured by JKL. JKL will retain coverage on the first 5% of the aggregate book risk of DEF's loan pool and ORG will assume all the losses on the next 5% layer. Any losses in excess of this second layer of loss coverage will be retained by JKL. The term of the reinsurance contract is for 10 years.

ORG 's initial year of operation, which did not begin until late in 20AA, provided less than $350,000 of reinsurance premium for JKL. As such, ORG is statutorily tax-exempt and is seeking recognition of such status.

ORG 's insurance activities are conducted in XYZ. ORG does not intend to employ any agent or broker to provide business for ORG outside of XYZ. ORG has engaged the services of the Insure Risk, an affiliate of UNR , to act as the insurance manager.

In Part II, Question 2 of the Form 1024, ORG indicated that its present and future support will be derived primarily from a capital contribution of $; continued insurance operations, and additional capital contributions based upon business needs.

ORG would be capitalized by selling 1000 shares, with a $ par value, for a capital contribution of $, by DEF. ORG received additional paid in capital of $ in cash from DEF. No dividends would be paid by ORG . ORG had less than $350,000 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 July 9, 20BB.

Part III of the application, Financial Data, reflects ORG 's actual figures for the short tax year of November 16, 20AA, through December 31, 20AA, and "proposed budgets" for 20BB and 20XX . Part III of the application shows revenue from insurance premiums in the amount of $ for 20AA (covering the period November 16, 20AA, through December 31, 20AA), with projected figures for insurance premium revenues of $ for 20BB, and $ for 20XX . In Schedule I, ORG reported reinsurance premiums of $ for the short year of 20AA. Part III reflects revenue from ORG 's investment income in the amount of $ for 20AA, with projected figures of $ and for 20BB and 20XX , respectively.

Under Part III, Assets, ORG lists "cash" of $ and "other assets" of $. Statement 2 of Form 1024 identifies the other assets as premium receivable ($) and interest receivable ($). No other assets were held by ORG at the filing of the Form 1024 application. ORG held no capital assets in 20AA.

The application was signed May 18, 20BB, by OFF1, President of ORG . No Form 2848, Power of Attorney was submitted with the Form 1024 application. In Part I, Question 3, POA1 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 __; Exhibit E, Assignment and Assumption of Membership Agreement with ; Exhibit F, Schedule of "other expenses" reported in Part III; and the aforementioned Exhibit G, description of "other investments."

The Service by letter dated June 12, 20BB, informed ORG that its Form 1024 application was transferred to the IRS National Office for ruling. The application was assigned to a Tax Law Specialist on June 20, 20BB. The Tax Law Specialist closed the application on July 6, 20BB, without requesting any additional information for the organization.

The Service issued a favorable determination letter to ORG on July 9, 20BB. 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 November 16, 20AA,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 State2 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 20AA, 20BB, 20XX , and 20YY. ORG did not qualify for tax-exempt status for 20ZZ, and therefore, filed Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return. In addition, the 20ZZ Form 1120-PC was the final return filed by ORG because the organization dissolved its corporate status as of December 31, 20ZZ. The Internal Revenue Service examined ORG 's Form 990 for the tax years ended December 31, 20XX and December 31, 20YY.

The Form 990 for 20XX was signed by the preparer at CPA, City office, on November 10, 20YY, and by OFF1, President on November 12, 20YY. ORG completed Form 8868 requesting an extension to November 17, 20YY. The 20XX Form 990 was filed on November 20, 20YY. The Form 990 for 20YY was signed by a tax preparer from CPA, New York office, on November 12, 20ZZ, and by the Treasurer of the board, CFO , also on November 12, 20ZZ. No approved extension is attached to the 20YY Form 990. Internal research revealed that ORG received an extension to file the 20YY return until November 15, 20ZZ. The return was received by the Ogden Service Center on November 23, 20ZZ.

On examination, it was determined ORG earned premium income of $ in 20XX and $ in 20YY, and investment income totaling $ in 20XX and $ in 20YY. 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 provide exceed mortgage loan reinsurance and direct insurance on second mortgage loans made by an affiliate, DEF. ORG does not insure or reinsure risks of parties other than customers of its affiliate, DEF.

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 interinsurers 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 10 through 29 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. 20ZZ-1, 20ZZ-1 I.R.B. 1; Rev. Proc. 90-27, 1990-1 C.B. 514.

The conclusion that ORG is 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 18 through 29 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.

Primary source of financial support. The Form 1024 application at Part II, line 2, requires an applicant to identify its primary source of financial support. ORG made the following representations: "ORG indicated that it was initially capitalized with $ by DEF. Financial support will be provided through continued insurance operations. Additional capital may be contributed to ORG based upon business needs and in conformity with safety and soundness guidelines applicable to federal savings associations."

On its Form 1024 application ORG represented that it was formed on November 16, 20AA. Financial information on the Form 1024 was presented for a short time frame from November 16, 20AA, through December 31, 20AA. ORG 's representation on the Form 1024 that it had actual revenue for 20AA 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 15.3% of ORG 's total revenue in 20AA.

The Form 1024 application provided projected revenues for 20BB and 20XX . ORG projected revenues from insurance premiums in the amounts of $ for 20BB, and $ for 20BB. In addition, the applicant projected investment income of $ for 20BB and $ for 20XX . Based on the proposed budgets, the insurance premiums represented 90.7% and 84.2% of ORG 's projected revenues for 20BB and 20XX , respectively, while the investment income was projected to constitute only 9.3 % and 15.79%.

Examination of ORG and related entities showed the source and amount of ORG 's "program service revenue" differ significantly from representations made in the Form 1024 application. ORG 's investment income, received in 20BB and 20XX , 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 20BB and 20XX , as reflected on the Form 1024 application, and actual revenue earned for the same years:

		FORM 1024 PROJECTIONS	ACTUAL REVENUE FIGURES FROM 990
20BB	program service revenue	$	$
	investment income		
	other revenue		
	Total	$	$
20XX	program service revenue	$	$
	investment income		
	other revenue		
	Total	$	$

In 20BB and 20XX , ORG 's actual premium income was far less than the projected premium income reflected on the Form 1024 application.

The most likely explanation for the substantial discrepancy between the projected and actual figures for 20BB and 20XX is the inaccuracy of the projected figures.

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

Form **886-A** (Rev. January 1994)	**EXPLANATIONS OF ITEMS**	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/31/20XX 12/31/20YY

ORG filed its Form 1024 application with the Service on May 23, 20BB (postmarked May 21, 20BB), approximately six months before the transfer of the COSTK shares from DEF to ORG was executed. Therefore, ORG 's shareholder and board members were more than likely aware of the planned reorganization of DEF; the subsequent formation of the mutual holding company structure; and reallocation of the COSTK shares owned by DEF. The reorganization plan is described in the August 10, 20BB, Prospectus, prepared by CPA The Service issued the tax-exempt ruling letter to ORG on July 9, 20BB, only one month prior to the issuance of the Prospectus. Therefore, discussions about the reorganization had to have been initiated well before the issuance of the Prospectus, and during the exemption application process. Yet, this information was not disclosed in the form 1024 application. If the information was adequately disclosed, the Service would have had an opportunity to determine whether ORG is overcapitalized.

ORG did not once come back to the Internal Revenue Service to correct its projected investment income for 20BB or 20XX , based on the fact that ORG received COSTK shares from DEF. Nor did ORG notify the Service that as a result of the reorganization, the 100% sole shareholder of ORG changed from FirstORG, to ABC. Prior to the reorganization, ORG was wholly owned by FirstORG, which in turn, was wholly owned by DEF. Subsequent to the reorganization, FirstORG no longer exists. The new parent of ORG is ABC, which in turn, is owned by GHI(%) and public stockholders (%). ORG was required by the conditions of ruling letter to notify the Service of any material changes in sources of income, purpose, and method of operation.

ORG was questioned about the lack of notification to the Service in Information Document Request Number 6, item 8, issued to ORG on February 13, 20ZZ. ORG responded to the IDR on March 15, 20ZZ. The exchange is noted below:

> <u>Question</u>
> "Other than filing the annual information return, Form 990, did the board of ORG take any steps to notify the IRS of the substantial changes in sources of support of the organization subsequent to the contribution of COSTK stock, as required by your Federal exemption letter?"
>
> <u>Response</u>

The change was a change in magnitude and the source remained the same so we did not notify the IRS of a change.

The change in income between that projected in the Form 1024 and actual income was significant because the change resulted from the contribution of a substantial income producing asset by DEF, i.e. $ of COSTK shares.

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 20XX and 20YY, was interest and dividends, earned from the COSTK shares received from its parent during the 20BB corporate reorganization, not insurance premiums.

  (2) Percentage comparison: This report at page 2 notes that ORG 's income from insurance premiums comprised only 10.01% of its total income for 20XX , and only 12.49% for 20YY. Over the two years under audit, the premium averaged only 11.37% of ORG 's total income. This percentage analysis treats ORG 's income of from the excess layer mortgage reinsurance 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 shares of COSTK stock to ORG as part of a corporate reorganization in 20BB. The shares were valued at approximately $ at the time of transfer. The transfer was made to fund ORG and for tax planning purposes. As of December 31, 20XX , and December 31, 20YY, ORG held net assets of $ and $, respectively, while it assumed a maximum insurance risk of only $ and $ for each year. In other words, ORG owned, on average, $214 dollars in net assets to each $1 of risk exposure under the excess layer mortgage loan reinsurance agreements. In addition, the ratio of net

assets to premiums was $607:1 for 20XX and $402:1 for 20YY. The ratios show that ORG is significantly overcapitalized for 20XX and 20YY.

The omission of details and facts about the corporate reorganization is material because the reorganization plan involved the reallocation of COSTK shares between the various entities, and a prime motivation could be to avoid payment of tax on the earnings of such shares.

ORG implemented an insurance strategy that was designed to minimize income tax consequences that would result if a substantial portion of the COSTK shares were sold. Instead of selling the shares, DEF implemented a strategy, based on the advice of CPA, which included the formation of a captive insurance company and the subsequent reallocation of % of DEF's COSTK shares to the captive. The primary benefit derived from the strategy is to defer or be exempt from taxation on captive income, including interest and dividends received by ORG from the COSTK shares.

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.

<u>Materiality analysis.</u> Facts (listed below) developed on examination, that were not provided by ORG on its Form 1024 application:

- The 20BB reorganization of DEF and plan to reallocate COSTK shares to ORG .

- A primary purpose for forming ORG was to allow DEF to get part of the premium for assuming part of the risk on the mortgage insurance the borrowers carry.

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 November 16, 20AA, 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 above. 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.

CONCLUSIONS:

A. ORG , 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 November 16, 20AA.