200808034

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

UIL: 501.15-00

Date: April 17, 2007

Legend
ORG = Organization name
Address = address
XX = Date

Release Date: 2/22/08

ORG
Address

Taxpayer Identification Number:
Form:
Tax Year(s) Ended:
Person to Contact/ID Number:
Contact Numbers:
Telephone:
Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear :

This is our final adverse determination letter as to your exempt status under I.R.C. § 501(c) (15) of the Internal Revenue Code. Our adverse determination was made because, for the year(s) of the examination, you were not operated as an "insurance company" within the meaning of I.R.C. § 501(c) (15) of the Internal Revenue Code. Your exempt status is revoked effective January 1, 20XX.

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

We have also enclosed Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues, and Publication 3498, *The Examination Process.* These publications include information on your rights as a taxpayer. They explain appeal rights and the procedure for obtaining technical advice.

Both technical advice and appeals procedures require a minimum of 180 days remaining on the statute of limitations. In order to take advantage of appeal rights or technical advice procedures, a taxpayer might be asked to execute a consent to extend the statute of limitations to permit Appeals consideration or submission of a request for technical advice. That was the situation in this case. Internal Revenue agents discussed with you the possible referral of this matter for technical advice. You declined that option. Internal Revenue agents also requested statute extensions. You elected not to extend the applicable statutes. As you are aware, the time remaining on the statutes does not allow for usual appeal procedures or submission of the case for technical advice.

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

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

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

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

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

Form 886A	Department of the Treasury - Internal Revenue Service **Explanation of Items**	Schedule No. or Exhibit
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ISSUES:

1. Is ORG providing insurance to its parent's customers?
2. Is ORG an insurance company exempt from Federal tax as an organization described under Internal Revenue Code (IRC) section 501(c)(15), for taxable years 20XX & 20XX?
3. Is ORG's primary and predominant activity that of insurance or investment activity?
4. Can ORG rely on the determination letter granted by the Service allowing it to claim tax exempt status pursuant to IRC § 501(c)(15)?
5. Is ORG entitled to relief under Internal Revenue Code Section 7805(b) or another other code section?
6. If ORG cannot rely on its determination letter, what is the effective date of revocation?
7. If ORG can rely on its determination letter, is it subject to revocation of exemption based on any other sections of the Internal Revenue Code?

FACTS

ORG (ORG) was formed on December 29, 19XX, in the State of XYZ. Its Articles of Incorporation states that it is organized to transact any and all lawful business for which corporations may be organized under the XYZ Business Corporation Act. At the time of formation ORG was a wholly-owned subsidiary of Company 1, (Company 1) a publicly traded company. The 4 officers and directors of ORG held less than % of Company 1 stock

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Company 1 designed, manufactured, marketed, sold and serviced motto for security and surveillance, industrial and medical video and professional audit markets. Company 1 worked through various subsidiaries and product lines in the Country 1, Country 2, Country 3, Country 4, and Country 5.

Company 1 sold its commercial products through various independent distributors/dealers and its consumer products through mass merchants. In addition, Company 1 sold "add-on" products through phone sales at its phone service center. The consumer products group accounted for approximately % of Company 1's total sales. The Consumer Projects were sold under the name brands Brand 1, Brand 2 and Brand 3. Company 1's commercial products were sold under the "Company 1" name brand. Commercial accounted for approximately % of Company 1's total sales.

Company 1 provided a standard 1 year manufacturer's warranty on each product. Through the creation of ORG, Company 1 began issuing an Extended Warranty Agreement (EWA) on its consumer projects, to its customers. The EWA program provided coverage for an advancement replacement of the covered product for covered mechanical and electrical defects only. The EWA extended the coverage provided by the manufacturer for a period of two or three years commencing on the expiration date of the original warranty period and ending on the date of expiration stated on the EWA.

Since the EWA was an advancement replacement program, when a consumer experienced and reported a covered defect, ORG would immediately provide replacement equipment to the consumer. ORG would pay Company 1 for the replacement inventory.

Upon the formation of ORG, a Business Plan was created. Highlights of the Business Plan included the following:

- Company 1 designs, manufactures, markets, sells and services innovative motto for the security & surveillance, industrial & medical video and professional audio markets worldwide.
- Company 1 provides a standard manufacturer's warranty of one year with all Company 1 products.
- Company 1 operates through various subsidiaries and product lines

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- Issue of an Extended Warranty Agreement to its customers
- ORG responsible for the overall administration of EWA program
- Sell Plus Extended Warranty Agreements to Company 1 customers
- Shareholder- Company 1
- Directors- Director 1-, Director 2 and Director 3
- Officers- Director 1, Director 3, Director 4
- Contractual relationship between ORG and the customer
- To comply with certain state law requirements as well as the terms of the agreement between and independent dealers and distributors, will in the future purchase reinsurance from an Company 1 subsidiary, Company 1 Insurance Company Ltd. (UICL) which will be licensed Insurance Company. UICL will be required to indemnify for an agreed percentage of the losses on replacements made pursuant to the warranties. will remain primarily liable to the holders of the contracts.

- ORG will implement a 4 step claims control program designed to maximize return
- % loss ratio
- capitalized with marketable securities and cash totaling $
- Balance sheet through 20XX- Estimated premiums by 20XX- $
- examples of products insured and prices per product

On January 5, 20XX, ORG filed Application Form 1024, Application for Recognition of Exemption Under Section 501(a), with the Service. Included with the application form was a copy of the Business Plan, Articles of Incorporation, and the Extended Warranty Program. ORG indicated that they were registering in various states as an Administrator Obligor. Such registration permitted ORG to offer the EWA and avoid regulation as an insurance company for state law purposes. ORG stated that an Administrator Obligor operated much like an "intersurer" and performs administrative, accounting and other business functions.

Based on the information supplied in its application form and other documents, ORG was issued a determination letter, dated March 15, 20XX, granting them exemption under section 501(c)(15) of the Internal Revenue Code of 1986. At the time of granting the exemption, the reinsurance company that was mentioned in the Business Plan had not been created.

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ORG reported the following income on its Form 990 for the taxable year 20XX & 20XX:

FORM 990 INFORMATION	20XX	20XX
Premiums		
Total Investment Income		
Gain on Sales of Property		
Other Income		
Total Revenue		
Total Assets		
Notes/Loans Receivable		

The majority of ORG's income during 20XX & 20XX was attributable to investment income. As can be seen below, only a very small portion of the income was attributable to ORG's insurance activity. Due to the lack of information provided by ORG, the number of policies issued for each year could not be determined.

REVENUE	20XX	20XX
Premiums		
Total Revenue		
Percentage- Total Premiums to Total Revenue		
Number of Policies Issued		

The Form 990 for year ending December 31, 20XX was selected for an examination. An Information Document Request (IDR), along with a cover letter and Publication 1 was mailed to the organization on March 14, 20XX. The IDR requested information on the activities of the organization as well as some financial information to verify that the organization qualified as an organization exempt under section 501(c)(15) of the Code, and filed an accurate Form 990.

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Only a small portion of the information requested was able to be secured. Information Document Request #2 was prepared and mailed August 17, 20XX, requesting the same information that was not provided in the prior IDR, as well as some additional questions.

Through numerous phone calls, letters and a conference call with the organization and its Powers of Attorney, it was stated that ORG ceased conducting business in 20XX and filed a filed a final return for the year ending December 31, 20XX. The decision to cease operations was largely based upon the level of business achieved, which was considerably less than the business plan.

One of the main reasons given for ORG to cease operations was that, in 20XX, Company 1 lost its main contract with to sell its equipment through their locations. After the loss of the contract, Company 1 sold % of its business and exited the security and surveillance business. Without this business, there were no products for ORG to provide extended warranties on.

After the sale of % of its business, Company 1 merged the remaining assets with Company 2 (Company 2). Upon dissolving of ORG, all assets were also merged with Company 2.

As indicated by the chart above, ORG had total assets of $ for 20XX, and $ for 20XX. Of these total assets, a majority were in notes/loans receivables. In 20XX, % was in notes/loans while for 20XX, % was in notes/loans. Copies of the note/loan agreements were not provided. However, through the examination it was determined that the loans were made to the parent company, first Company 1 and then Company 2.

As stated above, a large amount of the items requested in the two IDR's were not provided by the organization. In a letter dated August 12, 20XX, it was stated that ORG's parent company, Company 2 has undergone substantial downsizing and restructuring over the past 3 years. The operational and management personnel originally associated with ORG's business are no longer employed by Company 2 or any of its subsidiaries. Many of the records requested were archived in long term storage. In phone conversations with Director 5 of Company 2, it was stated that it would take an enormous amount of time to try to find the records requested, short of hiring back people that were involved in ORG and Company 1.

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In a letter from Company 2 dated September 9, 20XX, it stated that all of the assets of ORG were processed as a tax free distribution and cancellation of stock with the sole shareholder. This included the loans indicated on the Forms 990. The effective date of the distribution was at the close of business, December 31, 20XX. The final return for the organization as of December 31, 20XX reflected the ending assets at the moment prior to the distribution and there is not a filing to be made for 20XX.

LAW AND ANALYSIS

1. **Is ORG providing insurance to its parent's customers?**

The first issue is whether ORG is providing insurance to its parent's customers. Determining whether this qualifies as insurance will assist in determining whether ORG can qualify for exemption pursuant to IRC § 501(c)(15).

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

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

Risk shifting issues frequently arise in the case of captives. In Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), the court defined a "captive" in footnote 1 on page 1298 as,

> a corporation organized for the purpose of insuring the liabilities of its owner. At one extreme is the case presented here, where the insured is both the sole shareholder and only customer of the captive. There may be other permutations

involving less than 100% ownership or more than a single customer, although at some point the term "captive" is no longer appropriate.

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

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

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

In Revenue Ruling 20XX-90, 20XX-2 CB 985, the question was raised on whether a subsidiary's arrangement to provide liability insurance coverage to 12 of its parent company's subsidiaries constituted insurance contracts for federal tax purposes and

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thus, the amounts paid as premiums by each subsidiary were deductible as business expenses. Under the arrangement, the subsidiaries were charged arm's length premiums, according to customary industry ratings, and none had liability coverage of less than 5 percent or more than 15 percent, of the total risk insured by the subsidiary.

As a result, the professional liability risks of the 12 subsidiaries were shifted to the insurer subsidiary as required to constitute an insurance contract for federal tax purposes. The common ownership of the subsidiaries, including the insurer, by the parent, did not affect the determination that the arrangements constituted insurance contracts.

Due to the lack of information that ORG provided, it could not be determined whether there was either adequate risk shifting or risk distribution. ORG did not provide any information on who was insured, and how many were insured. Without this information, there is no way to determine if there was any risk shifting or risk distribution.

ORG was created to provide an extended warranty on products manufactured by its parent company, Company 1 and sold through distributors, phone sales and the internet. Based on the information provided in its application form, ORG received exempt status under section 501(c)(15) of the Code.

During the years under audit, it could not be determined if the extended warranty was being provided to Company 1's customers or how many customers actually purchased the warranties. IDR #1 and IDR #2 both requested an estimate on the number of policies sold in 20XX and what the estimated maximum exposure was in the same year. This information was not provided.

As stated in Revenue Ruling 89-61, 1989-1 C.B. 75, risk distribution refers to the operation of the statistical phenomenon known as the "the law of large numbers." When additional statistically independent risk exposure units are insured, although the potential total losses increase, there is also an increase in the predictability of average loss. This increase in the predictability of the average loss decreases the amount of the capital that an insurance company needs per risk unit to remain at a given solvency level. In the present case, there is no information on the number of policies insured to determine if there is the statistical phenomenon known as "the law of large numbers."

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There is no way to determine if there is any risk distribution, let alone adequate risk distribution.

Due to the lack of information ORG provided, it can not be determined if there is adequate risk shifting or risk distribution. Without being able to determine if there is adequate risk shifting or risk distribution, it can not be determined that ORG was providing insurance. Without ORG being able to show that they were providing insurance it can only be assumed that no insurance was being provided.

2. **Is ORG an insurance company exempt from Federal tax as an organization described under Internal Revenue Code (IRC) section 501(c)(15), for taxable year 20XX?**

The second issue is whether ORG is an insurance company exempt from tax pursuant to I.R.C. section 501(c)(15) for the taxable years 20XX & 20XX. I.R.C. section 501 provides that certain entities are exempt from taxation. Included in these entities are "[i]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. section 501(c)(15)(A)[1].

a. 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. sections 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. section 816 (formally I.R.C. section 801) defines a life insurance company. As part of this definition, I.R.C. section 816 provides, "the term 'insurance company' means

* * * *

[1] If an entity is 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. section 501(c)(15)(A). I.R.C. 501(c)(15)(B). In this case, there are no other premiums to aggregate with the premiums ORG received during 20XX & 20XX pursuant to I.R.C. 501(c)(15)(B).

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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. section 1.801-3(a)(1) defines an insurance company as,

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

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

Prior to 20XX, the Internal Revenue Service had 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 & 20XX, its primary and predominant business activity during that year must have been issuing insurance contracts or reinsuring insurance risks. See I.R.C. section 816; Treas. Reg. section 1.801-3(a)(1).

Several court cases 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. Layers 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 the 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.2nd 697 (9th Cir. 1972), the taxpayer issued and reinsured 17, 280, 325 and 424 insurance policies earning premiums of $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 estate and stock, earned 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 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

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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 book' 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 amount 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.

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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 from these years was small when compared with the 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 was held for insurance policy reserves. Id.

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

ORG should not be classified as an insurance company for tax purposes because its primary and predominant activity during the taxable years 20XX & 20XX was its

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investment activity, not its insurance activity. This is evidenced by the sources of ORG income during the years at issue. ORG reported the following income on its Forms 990 for the taxable years 20XX & 20XX:

FORM 990 INFORMATION	20XX	20XX
Premiums		
Total Investment Income		
Gain on Sales of Property		
Other Income		
Total Revenue		
Total Assets		
Notes/Loans Receivable		

The majority of ORG's income during 20XX & 20XX was attributable to investment income. As can be seen below, only a very small portion of the income was attributable to ORG's insurance activity. Due to the lack of information provided by ORG, the number of policies issued for each year could not be determined.

REVENUE	20XX	20XX
Premiums		
Total Revenue		
Percentage- Total Premiums to Total Revenue		
Number of Policies Issued		

ii. <u>ORG Failed to Use its Capital and Efforts Primarily to Earn Income from its Insurance Activity.</u>

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

During 20XX & 20XX, ORG purported to operate as an insurance company, insuring contracts with customers of its parent. Based on the following, however, ORG has failed to demonstrate that it concentrated its capital and efforts primarily on its insurance business: 1) ORG was extremely overcapitalized; 2) ORG devoted little, if any, time to developing and marketing its insurance products; 3) ORG did not employ anyone to solicit insurance business, it had no employees; 4) ORG devoted little time to its insurance activities.

First, relying on Bowers, ORG asserts that it held passive investments to secure the risks it undertook through its insurance activities. 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 did ORG require to support the risk it assumed by entering into its insurance contracts. ORG held passive investments worth approximately $ to cover anticipated insurance claims. Of these assets, approximately $ was in the form of loans to the parent organization Only approximately $ was available each year to cover any claims that would be filed. Over 99% of the assets held by ORG were tied up with the parent company and were not available for use if claims were filed. Even though ORG did not provide detailed information on the number of policies outstanding and the maximum exposure of those risks, it would appear that based on the assets held, there was only a small amount of risk involved. The imbalance of investment assets to ORG's risk shows that ORG's primary and predominant business activity during 20XX & 20XX was its investment activity; it's loans to its parent, not its insurance activity

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Second, ORG devoted little time to developing and marketing its insurance products. It was stated in a conference call with Company 2 and its POA's that in 20XX, the contract with was lost. After that Company 1 sold a majority of its business and merged with Company 2. There has been no indication that any new business was developed or marketed. ORG did not make any effort to promote or increase business. Once the contract was lost with , Company 1 proceeded to dissolve its operations. This resulted in ORG not having anyone to supply extended warranties to. No effort was made to seek extended warranties on other products or seek other types of insurance or reinsurance business.

Third, ORG did not employ anyone to solicit new 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 insurance 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).

ORG had no employees, no sales or clerical staff. No effort was made by anyone to solicit new business.

Fourth, ORG spent an insignificant amount of time on its insurance activity. Only a small amount of premiums were received. No new insurance contracts were sold after

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the loss of the account. According to the Forms 990 for 20XX & 20XX, no claims were filed. ORG continued to receive a substantial amount of investment income. ORG also provided additional money in the form of loans to its parent, Company 1. The amount of time spend on its investment activity, including loans to its parent, was significant compared to its time on its insurance activity.

3 Is ORG's primary and predominant activity that of insurance or investment activity?

primary and predominant business activity was its investment activity. During 20XX & 20XX, ORG received a small amount of its income from its insurance activity. As stated above, it could not be determined how many policies were sold during part of 20XX or how many policies were outstanding during 20XX & 20XX. During the years ORG did maintain investments including loans to its parent organization. Although ORG generated some premium from the policies outstanding, a majority of the income earned was from the investment activity. The primary and predominant activity conducted by ORG was maintaining its investments, not insurance activity.

4 Can ORG rely on the determination letter granted by the Service allowing it to claim tax exempt status pursuant to IRC § 501(c)(15)?

Under section 501(a) of the Code, organizations described in subsection 501(c) are exempt from federal income tax, unless such exemption is denied under section 502 or 503.

For taxable years prior to 20XX, 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)].

Section 501(c)(15)(B) of the Code provided that when an entity was part of a controlled group, all net written premiums (or direct written premiums) or net written premiums of the members of the group were aggregated to determine whether the insurance company met the requirements under section 501(c)(15)(A).

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Neither section 501(c)(15) of the Code, nor the regulations under that section define an "insurance company". Accordingly, 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.

Based on the facts presented above and the application of the law to those facts, it was determined that ORG was not an insurance company, therefore, ORG did not qualify for recognition of exemption from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(15) during 20XX and 20XX. Therefore, ORG cannot rely on its determination letter granted by the Service allowing it to claim tax exempt status pursuant to IRC 501(c)(15).

Therefore, 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 minimal amount of insurance activity

5 **Is ORG entitled to relief under Internal Revenue Code Section 7805(b) or another other code section?**

An organization may ordinarily rely on a favorable determination letter received from the Internal Revenue Service. Regulations 1.501(a)-1(a)(2); Rev. Proc. 20XX-4, 14.01 (cross-referencing 13.01 et seq.) 20XX-1 C.B. 514. 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. Regulations 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. Regulations 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. Regulations 601.201(m) (cross-referencing Reg. 601.201(l)); Rev. Proc. 90-27, 14, 1990-1 C.B. 514, 518.

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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. 20XX-4, 14.01 (cross-referencing 13.01 et seq.). 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. Regulations 601.201(n)(6)(i); Rev. Proc. 90-27, 14.01; Rev. Proc. 20XX-4 14.01 (cross-referencing 13.01 et seq.).

In cases where the organization omitted or misstated a material fact, revocation may be retroactive to all open years under the statute. Regulations 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. Regulations 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. Regulations 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 grated by I.R.C. 7805(b) to the Commissioner (or the Commissioner's delegate).

To request I.R.C. 7805(b) relief, the organization must submit a statement in support of this application of I.R.C. 7805(b), as described in Rev. Proc. 20XX-4, 14.02. See also Rev. Proc. 20XX-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 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. 20XX-4, 14.02(1) (cross-referencing 13.05),

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as they relate to the situation at issue. These five items are, in effect, the same as the factors provided in Regulations 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 a 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 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 determinant.

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. Regulations 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).

In this case, ORG did conduct itself as indicated in its original application form until it lost its contract with in 20XX. Since that time, ORG has been operating more as an investment company, receiving a substantial amount of its income from investments and loaning of its assets to its parent organization. Therefore, ORG is not entitled to relief under IRC§ 7805(b). ORG is also not entitled to any other relief that may be found under and other code sections.

6 If ORG cannot rely on its determination letter, what is the effective date of revocation?

The effective date of denial of exemption should be January 1, 20XX.

7 If ORG can rely on its determination letter, is it subject to revocation of exemption based on any other sections of the Internal Revenue Code?

Internal Revenue Code section 6033(a)(1) states that, except for the mandatory exceptions, every organization exempt from taxation under section 501(a) shall file an annual return, stating specifically the item of gross income, receipts and disbursements and such other information for the purpose of carrying out the Internal Revenue laws as the Secretary may by forms or regulations prescribe and shall keep such records, render under oath such statements, make such other returns and comply with such rules and regulations as the Secretary may from time to time prescribe.

Revenue Ruling 59-95, 1959-1 CB 627 states, in part, that failure or inability to file the required information return or otherwise to comply with the provision of section 6033 of the Code, and the regulations which implement it, may result in the termination of the exempt status of an organization previously held exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of exempt status.

Reg. 1.6033-2(h)(2) states that every organization which is exempt from tax, whether or not it is required to file an annual information return, shall submit such additional information as may be required by the Internal Revenue Service for the purpose of inquiring into its exempt status.

ORG was issued two Information Document Requests, requesting information pertaining to the examination of the organization and its activities. Through various correspondence and telephone calls with the organization it was determined that ORG was unable to provide a majority of the information requested in the IDR's. ORG's inability to provide the necessary information resulted in an incomplete examination.

ORG's inability to provide the necessary information to conduct a complete examination shows non-compliance with the Internal Revenue Code and Regulations. Therefore, if ORG is allowed to rely on its determination letter as an insurance company, its exemption should still be revoked for not meeting the requirements of Internal Revenue Code section 6033 and Reg. 1.6033-2(h)(2).

Effective date of this revocation should be January 1, 20XX.

<u>CONCLUSION</u>

1. ORG is NOT providing insurance to its parent's customers.

2. ORG is NOT an insurance company exempt from Federal tax as an organization described under Internal Revenue Code (IRC) section 501(c)(15), for taxable years 20XX & 20XX.

3. <u>primary and predominant</u> activity is its investment activity.

4. ORG can NOT rely on the determination letter granted by the Service allowing it to claim tax exempt status pursuant to IRC § 501(c)(15).

5. ORG is NOT entitled to relief under Internal Revenue Code Section 7805(b) or another other code section.

6. Exemption is denied effective for years beginning January 1, 20XX.

7. If ORG is allowed to rely on the determination letter granted by the Service based on being an insurance company, it can NOT rely on the determination letter based on failure to meet the requirements of Internal Revenue Code section 6033 and applicable regulations.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
678 Front Street, Suite 200
Grand Rapids, MI 49504-5335

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

November 8, 2005

Legend
ORG = Organization name   Address = address   XX = Date

ORG
Address

Taxpayer Identification Number:
Form:
990
Tax Year(s) Ended:
Person to Contact/ID Number:
Contact Numbers:
Telephone:
Fax:

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.

We have also enclosed Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues, and Publication 3498, *The Examination Process*. These publications include information on your rights as a taxpayer, including administrative appeal procedures within the Internal Revenue Service.

If you request a conference with Appeals, 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, the Appeals Office will advise you of its final decision

If you elect not to request Appeals consideration but instead accept our findings, please sign and return the enclosed Form 6018-A, *Consent to Proposed Adverse Action*. We will then send you a final letter modifying or revoking your exempt status under I.R.C. § 501(c)(15). 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 send a final letter advising of our determination.

In either situation outlined in the paragraph above (execution of Form 6018-A or failure to respond within 30 days), you are required to file federal income tax returns for the tax period(s) shown above, for all years still open under the statute of limitations, and for all later years. File the federal tax return for the tax period(s) shown above with this agent 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 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,

R. C. Johnson
Director, EO Examinations

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