

Internal Revenue Service

Department of the Treasury
TE/GE Division
450 Golden Gate Avenue, Stop 7-4-01
San Francisco, CA 94102

Release Number: **200836043**
Release Date: 9/5/08
Date: October 25, 2007
UIL Code: 501.15-00
Legend
ORG = Organization name
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

CERTIFIED MAIL - RETURN RECEIPT REQUESTED

Dear .

We have enclosed a copy of our report of examination explaining why we believe revocation 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 revoking your 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:

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	Year/Period ended 12/31/20XX

LEGEND

ORG = Organization name XX = Date Director = director XYZ = State
 CPA = CPA

ISSUE:

Whether ORG meets the new requirements for tax-exempt status, under IRC 501(c)(15), as described in the Pension Funding Equity Act of 2004?

FACTS:

The organization was originally incorporated in the State of XYZ, on December 30, 19XX, under the name, ORG, under the XYZ Non-Profit Corporation Act.

The ORG (hereinafter "ORG") is formed for the purpose of providing a guarantee fund for self-insurers to protect the workers and the families of workers employed by self-insurers who become insolvent. The Corporation is designed to help ensure the integrity and financial health of the workers' compensation and occupational disease disablement systems as it applies to self-insurers in XYZ.

The ORG is not authorized to issue shares of capital stock. The ORG's governance and operations are regulated by the _____ Act, Section _____ through _____, as amended (the "Act") and rules and regulations promulgated thereto.

The ORG is governed by a five member Board of Directors, pursuant to Section _____, including the Director of the XYZ State Workers' Compensation Administration, who is required by law to hold a board position. The remaining board members are elected from the general membership of the ORG.

Internal Revenue Service records reveal that the ORG was granted exemption as a small insurance company described in section 501(c)(15) of the Internal Revenue Code on July 22, 19XX, effective for all tax years subsequent to December 31, 19XX, when net written premiums (or, if greater, direct written premiums) do not exceed \$.

The ORG is required to file annual information return, Form 990, and employment tax returns Forms 941 and 940. The Form 990 return filed for the year ended December 31, 20XX was examined by TE/GE, City Post of Duty. During the initial inspection of the Form 990 for 20XX, it was noted that the corporation accurately reported being exempt under IRC 501(c)(15) on line J in the heading of the return.

Since the passage of the Pension Funding Equity Act of 2004, the ORG filed Form 990 returns for tax years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX. On its Form 990 returns, the ORG reported the following sources of income:

20XX 20XX 20XX

Gifts, Grants and Contributions

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Program Service Revenue
 Membership dues/assessments
 Interest on savings
 Interest on Restricted Funds
 Other income
 Totals

During the examination of the 20XX Form 990, it was determined that the primary activity of the ORG is to create of fund for self-insured businesses in the State of XYZ to meet future workers' compensation claim obligations in case of insolvency. The ORG is to be used as a "last resort" to provide benefits to workers and the families of workers of self-insurers who become insolvent and otherwise are unable to meet their financial obligations. The ORG does not maintain offices and paid staff. Under State law, the Workers' Compensation Administration is required to provide office space, staff and supplies as needed by the ORG.

The ORG is available to every private, individual certified self-insurer in the State of XYZ. During 20XX, the ORG was comprised of business members. The membership is comprised of three categories: small businesses (300 or fewer XYZ employees); medium businesses (301 to 2500 XYZ employees); and large businesses (2501 or more XYZ employees). Under State law, the ORG is not considered to be either a State agency or an insurance company.

The operations of the ORG are defined under the Act. The Act defines the purpose, rights, privileges, benefits, and obligations of those eligible to participate in the self-insured fund. The ORG is funded by member assessments. Section of the Act, states the following:

The fund may be used to pay benefits to workers or legal representatives of the worker that are required of the self-insurer who becomes insolvent and otherwise unable to meet his financial obligations, provided that the injury or death occurred on or after January 1, 19XX, or, in the case of an occupational disease, that the last injurious exposure occurred on or after January 1, 19XX.

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During 20XX, the ORG received assessments from two members totaling \$. The assessments were reported as "membership dues and assessments" on line 3, Part I, of the Form 990 for 20XX. No other members were required to pay assessments during the year. Similar reporting was made by the organization on its 20XX and 20XX Form 990 returns. During the exemption application process, the Service granted exemption to the ORG, under IRC section 501(c)(15), based on an understanding that the membership assessments would be treated as "premium" income for purposes of meeting the requirements under IRC section 501(c)(15) and reporting on Form 990. In a letter dated June 1, 19XX, Director, Director, agreed to treat the contributions and assessments from ORG members as "premiums" for purposes of determining the current and future eligibility for exemption as a small insurance company under section 501(c)(15) of the Code.

Addition sources of gross receipts consisted of interest on its checking account (\$), Certificate of Deposits (\$), and Restrict Surety Funds (\$). Gross receipts were less than the \$600,000 and \$150,000 limitations imposed by the Pension Funding Equity Act of 2004. However, based on the data reported on the 20XX Form 990, the amount of premiums did not meet either the 50% or 35% of gross receipts.

The ORG incurred minimal administrative costs during 20XX. However, no insurance losses were claimed or paid in 20XX.

There is no evidence of any other significant activities conducted by the ORGs during 20XX.

Although the ORG is operated as an insurance company, since more than half of its business during the year involved the insuring of insurance or reinsuring of insurance risks, the ORG does not qualify for tax-exempt status under IRC 501(c)(15), for years subsequent to the passage of the Pension Funding Equity Act of 2004, because it failed to meet the new requirements for tax-exempt status.

LAW:

PRIOR LAW

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). 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).

The prior law was effective for tax years beginning after December 31, 1986, through December 31, 2003, the effective date of the Pension Funding Equity Act of 2004.¹

CURRENT LAW

¹ Prior to 1986, the direct or net written premium ceiling was limited to \$150,000. The Tax Reform Act of 1986 increased the direct or net written premium ceiling to \$350,000 per year.

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For tax years beginning after December 21, 2003, an organization must meet the following two-part test to qualify for exemption under IRC 501(c)(15):

1. Gross receipts for the year may not exceed \$600,000 and
2. Premiums must be 50% or more of the organization's total gross receipts.

Mutual insurance companies must meet either the above test, or the following alternative test:

1. Gross receipts for the year may not exceed \$150,000 and
2. Premiums must be 35% or more of the organization's total gross receipts.

The alternative test for a mutual insurance company does not apply if an employee of the company, or a member of the employee's family [as defined in IRC section 2032A(e)(2)] is an employee of another company exempt from tax (or would be exempt) under IRC section 501(c)(15).

If an organization is in a receivership, liquidation, or similar proceeding under the supervision of a state court on April 1, 2004, the new law applies to taxable years beginning after the date such proceeding ends or December 31, 2007, whichever is earlier.

GOVERNMENT'S POSITION:

Internal Revenue Code section 501(c)(15) originally referred only to certain mutual insurance companies or associations other than life or marine. The Tax Reform Act of 1986 ("TRA-86") eliminated the distinction between small mutual insurance companies and other small insurance companies and extended exemption under IRC 501(c)(15) to all eligible small insurance companies, whether stock or mutual.

TRA 86 also changed the nature of the ceiling amount for tax exemption from certain gross receipts to direct or net written premiums. The ceiling amount was changed from \$150,000 to \$350,000. Therefore, under TRA 84, to qualify for exemption as a small insurance company, the direct or net written premiums received by an organization could not exceed \$350,000 for a taxable year.

The requirements established under TRA 86 posed serious problems for the Service, because the requirements did not place any limitation of the amount of investment income small insurance companies could earn. Many taxpayers and tax professionals took advantage of the tax-exempt treatment allowed to small insurance companies by contributing highly appreciated income producing assets to the tax-exempt organizations. The assets produced substantial investment income that was not taxed due to the tax-exempt status of the small insurance companies.

Congress intended to curb this loophole in the law by including language in Section 206 of the Pension Funding Act of 2004, which, one again, changed the requirements for tax-exempt status for Small Property and Casualty Insurance Companies.

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On April 10, 2004, President Bush signed H.R. 3108, the Pension Funding Equity Act of 2004, P.L. 108-218. One purpose of the legislation was to tighten the rules for property and casualty insurance companies to qualify as tax-exempt under section 501(c)(15) of the Code, or to elect to be taxed only on their investment income. The bill contained the following comments from the Conference Report:

The limitation to mutual companies and the limitation on employees are intended to address the conferees' concern about the inappropriate use of tax-exempt insurance companies to shelter investment income, including in the case of companies with gross receipts under \$150,000. It is intended that the provision not permit the use of small companies with common owners or employees to shelter investment income for the benefit of such owners or employees.

The new legislation amended IRC 501(c)(15) for tax years beginning after December 31, 2003. The new law replaced the "written premiums test" with a "gross receipts and percentage of premiums test."

The new law placed an overall limitation on the amount of gross receipts small insurance companies could earn for each taxable year.

Therefore, for years beginning after December 31, 2003, small insurance companies could not have gross receipts in excess of \$600,000 to qualify for tax-exempt status under IRC 501(c)(15). In addition, of its total gross receipts, 50% or more must be derived from premium income.

The facts present in this case, clearly demonstrate that the ORG does not meet the new requirements for tax-exempt status under IRC 501(c)(15), in 20XX, because its gross receipts do not consists of adequate "premiums" to meet the 50% or 35% tests imposed by the new law. Furthermore, the corporation also failed to meet the new requirements for exemption under IRC 501(c)(15) for tax years ended December 31, 20XX, and December 31, 20XX, for the same reason. Based on the audit, and the understanding between the ORG and Service to treat the member assessments as "premium," the ORG's gross receipts are as follows:

20XX 20XX 20XX

Gifts, Grants and Contributions
Program Service Revenue: Premium
Membership dues/assessments
Interest on savings
Interest on Restricted Funds
Other income
Totals

**Do Gross Receipts exceed
the \$ limitation?** No No No

50% of Gross Receipts \$

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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Premiums Received \$
Do Premiums exceed 50% of Gross Receipts? No No No

ALTERNATIVE TEST

Do Gross Receipts exceed the \$ limitation? No No No

35% of Gross Receipts \$

Premiums Received

Do Premiums exceed 35% of Gross Receipts? No No No

The principal and alternative gross receipts tests consist of two parts. The corporation must satisfy both parts of the \$600,000/50% gross receipts test or the \$150,000/35% alternative test. In this case, the ORG does meet part-one of the \$600,000 and \$150,000 gross receipts limitations permitted for small insurance companies. However, the ORG does not satisfy part-two of either test. The ORG must satisfy both parts of either the \$600,000/50% or the \$150,000/35% tests in order to meet the new requirements for tax-exempt status under section 501(c)(15) of the Code. If the ORG fails to meet one part of either test, then it fails to qualify for exemption as a small insurance company.

Based on the above analysis, it is determined that the ORG was properly recognized as a tax-exempt mutual insurance company for years prior to December 31, 20XX. However, due to the change in law, the corporation no longer qualifies for tax-exempt status for tax years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX, because it is not operated as a small insurance company since it fails to comply with the gross receipts tests imposed by the Pension Fund Equity Act of 2004.

As such, it is recommended that the corporation's tax-exempt status under IRC 501(c)(15) be revoked, effective January 1, 20XX.

TAXPAYER'S POSITION:

Form 5701, Notice of Proposed Adjustment, was mailed to the ORG's representative, CPA, CPA, on September 27, 20XX. The purpose of the Form 5701 was to explain the change in law applicable to small tax-exempt insurance companies, and to explain the nature of the proposed revocation of tax-exempt status, effective January 1, 20XX.

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No response to the Form 5701 was received from the CPA by the October 17, 20XX due date. Therefore, a telephone call was placed to CPA, CPA, on October 24, 20XX, to follow-up. was unavailable, so a message was left on her voice mail.

In addition, no response was received from the CPA regarding the Service's request for consent, Form 872, to extend the statute of limitations for calendar year 20XX, made on October 17, 20XX.

CONCLUSION:

A. ORG is an insurance company pursuant to Subchapter L of the Code for the taxable years 20XX, 20XX, and 20XX.

B. Although the ORG is an insurance company pursuant to Subchapter L of the Code, it does not qualify as a tax-exempt small insurance company because its gross receipts do not consists of adequate "premiums" to meet either the \$600,000/50% or the \$150,000/35% gross receipts tests imposed under IRC 501(c)(15) of the Internal Revenue Code (and related legislation), as described in the Pension Funding Equity Act of 2004.

C. Therefore, revocation of the ORG's tax-exempt under IRC 501(c)(15) is proposed, effective January 1, 20XX.

D. The ORG is required to file income tax returns for calendar years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX.



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
1100 Commerce St. – 4920 DAL
Dallas, TX 75242

05/19/2008

LEGEND

ORG = Organization name Address = address XX = Date
UIL: 501.15-00

ORG
ADDRESS

Taxpayer Identification Number:
Form:
Tax Year(s) Ended:
December 31, 2004
Contact/ID Number:
Contact Numbers:
Telephone

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.

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 892.

You have filed taxable returns on Forms 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return, for the year(s) ended December 31, 20XX, December 31, 20XX, and December 31, 20XX, with us. For future periods, you are required to file income tax returns with the appropriate service center indicated in the instructions for the return.

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 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

Enclosure
Publication 892