



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

Number: **200903094**
Release Date: 1/16/2009

October 2, 2008

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

ORG
ADDRESS

Taxpayer Identification Number:
Form:
Tax Year(s) Ended:

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

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate

assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 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,

Vicki L.Hansen, Acting,
Director, EO Examinations

Enclosure
Publication 892

Internal Revenue Service

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

Date: January 15, 2008

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 :

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 12/31/20XX

LEGEND

ORG = Organization name XX = Date City = city XYZ = State CEO = CEO
CO-1, CO-2 & CO-3 = 1st, 2nd & 3rd Companies Attorney-1 & Attorney-2 = 1st & 2nd Attorney

ISSUE:

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

FACTS:

ORG (hereinafter "ORG") was incorporated on October 25, 20XX, in City, XYZ, under the City Business Corporation Ordinance 19XX. The primary purposes for which the corporation was formed are:

1. To engage in any lawful act or activity for which corporations may be organized under the Ordinance;
2. Without prejudice to the generality of clause (1) hereof to transact all or any kinds of re-insurance business in any part of the world save and except in the Federation of City and City;
3. To do all such things as may be deemed incidental or conducive to the attainment of the above objects or either of them including (where necessary) the application for all requisite licenses and governmental or other consents under any relevant ordinance or regulations thereunder in force from time to time.

The purposes of the Corporation are to be carried out and conducted mainly outside City in conformance with section 123(20) of the Ordinance. The liability of members is limited. The corporation is authorized to issue shares of \$ per share. CEO, of City, XYZ, and owner of shares, is the sole shareholder of the corporation.

The registered office of the corporation is located in City, City, City and City, XYZ. The Registered Agent of the corporation is CO-1

CEO, the sole shareholder and President of the corporation, filed an election under Internal Revenue Code section 953(d) to be treated as a domestic corporation for United States tax purposes, in May 20XX.

Internal Revenue Service records reveal that ORG was granted exemption as a small insurance company described in section 501(c)(15) of the Internal Revenue Code on July 29, 20XX, commencing January 1, 20XX, for all tax years when net written premiums (or, if greater, direct written premiums) do not exceed \$. The ruling letter also included the following caveat:

For tax years beginning after January 1, 20XX, you are exempt 9f (a) your gross receipts for the taxable year do not exceed \$ and (b) more than 50 percent of your gross receipts for the taxable year consists of premiums. See section 501(c)(15)(A)(i) of the Code. For purposes of these tests, amount received by

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entities affiliated with you are taken into account if the entities are members of your controlled group.

ORG is required to file annual information return, Form 990. The Form 990 return filed for the year ended December 31, 20XX, was examined by TE/GE, San Francisco Post of Duty. During the initial inspection of the Form 990 for 20XX, it was noted that ORG 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, ORG filed Form 990 returns for tax years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX. On its Form 990 returns filed for the years ended December 31, 20XX, and December 31, 20XX, ORG reported the following sources of income:

	20XX	20XX
Gifts, Grants and Contributions	-0-	-0-
Program Service Revenue		
Membership dues/assessments	-0-	-0-
Interest on savings		
Dividends		
Gain of Sale of Assets		
Other income	<u>-0-</u>	<u>-0-</u>
Totals		

During the examination of the 20XX Form 990, it was determined that the primary activity of ORG is to accepted reinsured risk that originated as life, accident and health, "GAP", and vehicle service contract coverage policies, with Protective Life Insurance Company as the direct writer and administrator. CEO, sole shareholder and President of ORG is also a 30% owner of CO-2, located in City, XYZ. The auto dealership is the primary risk that is ultimately reinsured by ORG.

In 20XX, ORG ceased accepting new reinsurance business and went into run-off status as a reinsurance company. During the year under audit (20XX), the sole activity of ORG is to pay off remaining claims on the various risks reinsured, and to make reimbursements for any policies cancelled by the consumer. ORG held liquid assets (cash and securities) of approximately \$ to meet this purpose. ORG reimbursed premiums of \$ to consumers in 20XX. The reimbursements are reported as negative "premium" income on the 20XX Form 990.

Additional sources of gross receipts consisted of interest on its savings and investment accounts (\$) and the gain of sale of publicly traded securities (\$).

ORG's gross receipts are less than the \$ limitation imposed by the Pension Funding Equity Act of 2004. However, based on the data reported on the 20XX Form 990, premiums did not constitute 50% or more of the corporation's gross receipts.

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

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Although ORG was is "run-off" status in 20XX, the corporation is operated as an insurance company, since more than half of its business during the year involved the insuring or reinsuring of insurance risks. However, ORG does not qualify for tax-exempt status under IRC 501(c)(15), for the 20XX tax year, 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

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):²

1. Gross receipts for the year may not exceed \$600,000 and
2. Premiums must be more than 50% 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 more than 35% 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).

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.

² Notice 2006-42, I.R.B. 2006-19, April 24, 2006.

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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 \$. 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 \$ 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.

On April 10, 20XX, 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 \$. 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, 20XX. The new law replaced the "written premiums test" with a "gross receipts and percentage of premiums test."

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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, 20XX, small insurance companies could not have gross receipts in excess of \$ 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 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% test imposed by the new law. During the 20XX tax year, ORG did not receive premium income. On the Form 990 return, ORG reported negative premiums of (\$), which represented reimbursement of premiums to consumers for cancellation of the insurance policies. In addition, ORG also reported negative premiums of \$ for 20XX. The amounts were reported on the returns as a negative income item instead of reporting such reimbursements as an expense item. For purpose of calculation gross receipts for 20XX and 20XX, the amount of reimbursements was disregarded. Based on the audit, ORG's gross receipts are as follows:

	20XX	20XX
Gifts, Grants and Contributions	-0-	-0-
Program Service Revenue	-0-	-0-
Membership dues/assessments	-0-	-0-
Interest on savings		
Dividends		
Gain of Sale of Assets		
Other income	<u>-0-</u>	<u>-0-</u>
Totals		

Do Gross Receipts exceed the \$600,000 limitation? **No** **No**

50% of Gross Receipts

Premiums Received \$ -0- -0-

Do Premiums exceed 50% of Gross Receipts? **No** **No**

The principal gross receipts tests consist of two parts. The corporation must satisfy both parts of the \$/50% gross receipts test. In this case, ORG does meet part-one of the \$ gross receipts limitation permitted for small insurance companies. However, ORG does not satisfy part-two of the gross receipts test because its premium income does not exceed 50% of gross receipts for 20XX and 20XX. ORG must satisfy both parts of the \$/50% gross receipts test in order to meet the new requirements for tax-exempt status under section 501(c)(15) of the Code. If ORG fails to meet either part of the two part test, then it fails to qualify for exemption as a small

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insurance company. **Note: As a stock corporation, the alternative gross receipts test (\$/35%) is not available to ORG.**

Based on the above analysis, it is determined that ORG is properly recognized as a tax-exempt small 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 the tax year ended December 31, 20XX, and December 31, 20XX, because it fails to comply with the \$/50% gross receipts test imposed by the Pension Fund Equity Act of 2004.

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

TAXPAYER'S POSITION:

The proposed revocation issue was discussed with ORG's representatives, attorneys, Attorney-1 and Attorney-2, from CO-3, during a conference held on December 4, 20XX.

CONCLUSION:

- A. ORG is an insurance company pursuant to Subchapter L of the Code for the taxable year 20XX and 20XX.
- B. Although 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 the \$/50% gross receipts test, as described in the Pension Funding Equity Act of 2004, required of entities that qualify for exemption under IRC 501(c)(15) of the Internal Revenue Code.
- C. Therefore, revocation of ORG's tax-exempt under IRC 501(c)(15) is proposed, effective January 1, 20XX.
- D. ORG is required to file an income tax return for calendar year ended December 31, 20XX and December 31, 20XX.