UIL 501.15-00

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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February 20, 2008

Taxpayer Identification Number:

Form:
990
Tax Year(s) Ended:
December 31, 20XX & 20XX
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,

Marsha A. Ramirez
Director, EO Examinations

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

cc:

| Form 886A | Department of the Treasury - Internal Revenue Service<br>**Explanation of Items** | Schedule No. or Exhibit |
|---|---|---|
| **Name of Taxpayer** | | **Year/Period Ended**<br>12/31/20XX<br>12/31/20XX |

## ISSUES

1. Does qualify for tax exempt status under Internal Revenue Code (IRC) Section 501(c)(15), for the years beginning January 1, 20XX?

2. If does not qualify for tax exempt status for years beginning January 1, 20XX, what are the tax consequences?

3. If the tax exempt status is revoked, how will it affect future years?

## FACTS

( ) was formed in 18XX, in , by property owners, to provide insurance on a mutual basis. is chartered as a under Chapter of the .

On March 2, 19XX, received a letter from the Internal Revenue Service stating that they received tax exempt status on January 22, 19XX.

is divided into seven districts. Each district is made up of surrounding counties. Each district has its own licensed appraiser. These appraisers write the new business and also handle the claims for the districts.

Any person who has property that meets the underwriting guidelines and lives within 100 miles of the organization can become a policyholder. All persons having their property insured by are members the organization. At the end of 20XX there were 0 members holding policies. At the end of the same year, there was in force. Of that, was reinsured per the reinsurance contract discussed below.

has only one policy that it issues. The policy covers fire, lightning, wind storm, hail, explosion, riot, civil commotion, smoke, aircraft and land vehicles, theft coverage, vandalism, and sudden and accidental release of water.

Premiums and assessments are assessed against the members. A portion of the premiums are reinsured with , . , , , and under one contract. Policies classified as fire and allied lines, inland marine, homeowners and farmowners and commercial multi-peril, written or renewed by . Cessions are limited to an amount equal to four times net retention, subject to a minimum net retention of $0 and to a maximum cession of $0 on any one risk. If the cession is greater than $0, the maximum cession as respects any one animal shall not exceed $0. receives a commission of 0% on all premiums that are ceded.

Any claims that are filed are filed with . is responsible for paying the claims. Under the reinsurance agreement, will be reimbursed the amounts that the organizations in the agreement are liable for.

Forms 990 were filed for the 20XX & 20XX tax years. The following is a breakdown of the Gross Receipts received by for the years ending December 31, 20XX & 20XX, and the percentage of Gross Premiums to Gross Receipts for the same years per Notice 2006-42.

| | 20XX | 20XX |
|---|---|---|
| Total Premiums/Assessments | $0 | $0 |
| | | |
| Interest Income | $0 | $0 |
| Dividend Income | $0 | $0 |
| Gain On Sale of Securities | $0 | $0 |
| | | |
| Total Gross Receipts | $0 | $0 |
| | | |
| Percentage- Gross Premium/Reinsurance Income to Gross Receipts | % | )% |

The total amount of commissions and the total amount of claim payments received from the reinsurer are deducted from the total amount of premiums reinsured and are not considered a part of the gross receipts.

An election under IRC 831(b) has never been filed. As of the writing of this report, there has never been a filing of the election, either with the filing of the Forms 990 or separately.

## LAW AND ANALYSIS

**1. Does qualify for tax exempt status under Internal Revenue Code (IRC) Section 501(c)(15) for the years beginning January 1, 20XX?**

Internal Revenue Code section 501(c)(15)(A) exempts from Federal income tax insurance companies (as defined in section 816(a)) other than life (including interinsurers and reciprocal underwriters) if-

(i.) (I) the gross receipts for the taxable year do not exceed $600,000, and
(II) more than 50 percent of such gross receipts consist of premiums, or

(ii.) in the case of a mutual insurance company-
(I) the gross receipts of which for the taxable year do not exceed $150,000 and,
(II) more than 35 percent of such gross receipts consist of premiums.

Clause (ii) shall not apply to a company if any employee of the company, or a member of the employee's family (as defined in section 2032(A)(e)(2), is an employee of another company exempt from taxation by reason of this paragraph (or would be so exempt but for this sentence).

Sec. 206, Clarification of Exemption from Tax for Small Property and Casualty Insurance Companies, of the Pension Funding Equity Act of 2004, P.L. 108-218, amended section 501(c)(15)(A) to change the definition of small property and casualty insurance companies (insurance companies other than life insurance companies) exempt from income taxes to: (1) a company whose gross receipts for the taxable year do not exceed $600,000, and over half such gross receipts consist of premiums (currently, whose net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000); or (2) a mutual insurance company (a) whose gross receipts for the taxable year do not exceed $150,000 and more than 35 percent of which consist of premiums and (b) none of whose employees (or member of the employee's family) is an employee of another company exempt from tax under section 501(c)(15). These changes were applicable after December 31, 2003.

Notice 2006-42, IRB, 2006-19 provides guidance as to the meaning of "gross receipts" for purposes of section 501(c)(15)(A) of the Internal Revenue Code. This notice advises taxpayers that the Service will include amounts received from the following sources during the taxable year in "gross receipts" for purposes of § 501(c)(15)(A):

A. Premiums (including deposits and assessments), without reduction for return premiums or premiums paid for reinsurance;

B. Items described in § 834(b) (gross investment income of a non-life insurance company); and

C. Other items that are properly included in the taxpayer's gross income under subchapter B of chapter 1, subtitle A, of the Code.

Thus, gross receipts include both tax-free interest and the gain (but not the entire amount realized) from the sale or exchange of capital assets, because those items are described in § 834(b). Gross receipts do not, however, include amounts other than premium income or gross investment income unless those amounts are otherwise included in gross income. Accordingly, the term gross receipts does not include contributions to capital excluded from gross income under § 118, or salvage or reinsurance recovered accounted for as offsets to losses incurred under § 832(b)(5)(A)(i).

Section 834(b)(1)(D) of the Internal Revenue Code includes under gross receipts the gains from the sale or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses).

Section 834(c)(6) of the Internal Revenue Code allows a deduction for Capital Losses to the extent provided in subchapter P (section 1201 and following) plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders.

Based on the changes in the limitations under Internal Revenue Code (IRC) Section 501(c)(15)(A), and the operation of during 20XX & 20XX, it was determined from the chart above that did not qualify for tax exempt status for years beginning January 1, 20XX. was able to meet the 50% requirement of Gross Premiums to Gross Receipts both years % in 20XX & % in 20XX), however, their gross receipts exceeded the $600,000 limitation for both years (20XX- $0 ; 20XX- $0). Since their gross receipts exceeded the $600,000 limitation, they automatically exceeded the $150,000 limitation allowed for mutual insurance companies.

Section 206(e) of the Pension Funding Act of 20XX, P.L. 118-218 provides the effective date of the new requirements for exemption under IRC 501(c)(15). It states:

**EFFECTIVE DATE-**

(1) **IN GENERAL**- Except as provided in paragraph (2), the amendments made by this section shall apply to **taxable years beginning after December 31, 2003.**

(2) **TRANSITION RULE FOR COMPANIES IN RECEIVERSHIP OR LIQUIDATION**- In the case of a company or association which--

(A) for the taxable year which includes April 1, 2004, meets the requirements of section 501(c)(15)(A) of the Internal Revenue Code of 1986, as in effect for the last taxable year beginning before January 1, 2004, and

(B) on April 1, 2004, is in a receivership, liquidation, or similar proceeding under the supervision of a State court,

the amendments made by this section shall apply to taxable years beginning after the earlier of the date such proceeding ends or December 31, 2007.

was not involved in a court ordered liquidation during 20XX & 20XX. Therefore, Section 206(e)(2) does not apply to this organization.

Therefore, for the years beginning January 1, 20XX, did not qualify for tax exempt status under IRC 501(c)(15).

**2. If does not qualify for tax exempt status for years beginning January 1, 20XX, what are the tax consequences?**

Since did not qualify for tax exempt status under IRC Section 501(c)(15) for the years beginning January 1, 20XX, tax exempt status should be revoked for years beginning January 1, 20XX. filings of the Form 990 were incorrect. should have filed Form 1120-PC for years beginning January 1, 20XX.

IRC 831 discusses tax on insurance companies other than life insurance companies.

IRC 831(a) states as a general rule, "Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company other than a life insurance company."

IRC 831(b) provides an alternative tax for certain small companies. It states in IRC 831(b)(1) that, in general, "In lieu of the tax otherwise applicable under subsection (a), there is hereby imposed for each taxable year on the income of every insurance company to which this subsection applies a tax computed by multiplying the taxable investment income of such company for such taxable year by the rates provided in section 11(b)."

IRC 831(b)(2) discusses the companies to which this subsection applies.

(A) In general. This subsection shall apply to every insurance company other than life (including interinsurers and reciprocal underwriters) if-

(i) the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $1,200,000, and

(ii) such company elects the application of this subsection for such taxable year.

The election under clause (ii) shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements of clause (1) are met. Such election, once made, may be revoked only with the consent of the Secretary.

Regulations (Regs.) 301.9100-8(a)(2) discusses the time for making elections. Under (i) it states in general that except as otherwise provided in this section, the elections described in paragraph (a)(1) of this section, must be made by the later of-

(A) The due date (taking into account any extensions of time to file obtained by the taxpayer) of the tax return for the first taxable year for which the election is effective, or

(B) January 22, 1990 (in which case the election generally must be made by amended return)

Regs. 301.9100-8(a)(1) mentioned above includes IRC 831(b)(2)(A).

Regs. 301.9100-8(a)(3) describes the manner of making elections. It states, " Except otherwise provided in this section, the elections described in paragraph (a)(1) of this section must be made by attaching a statement to the tax return for the first taxable year for which the election is to be effective."

Based on the Code and Regulation sections above, is not entitled to the relief under 831(b), for years under examination and for any future year, until they decide to file the election. The election has never been filed, either with the Form 990 or separately. Any election filed now or in the future would only be effective for the year the election was filed and all subsequent years. The election can not be made retroactive.

**3. If the tax exempt status is revoked, how will it affect future years?**

The tax exempt status should be revoked for the years beginning January 1, 20XX. Form 1120-PC is required for each year and all future years where does not qualify for exemption. If meets the requirements under IRC 501(c)(15) in future years, it may be allowed to file the Form 990 for each year they qualify, as a self-declared entity. Otherwise, Form 1120-PC would be required. Any year in the future that the Form 1120-PC is required, is allowed to make an election under IRC 831(b). Once the election is made, it is effective for the year the election was made and for all future years that the Form 1120-PC is required. The election can not be made retroactive.

## TAXPAYER'S POSITION

Unknown at the time of this writing

## SUMMARY

It is the Governments position, based on the above facts, law and analysis, that the tax exemption status of for the years beginning January 1, 20XX, should be revoked based on not meeting the qualifications for exemption under IRC 501(c)(15). Form 1120-PC would be required to be filed for any year where does not qualify for exemption under IRC 501(c)(15).