



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE: EO Examinations

625 Fulton Street, Room 503

Brooklyn, NY 11201

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

February 15, 2008

UIL Code: 501.15-00

Release Number: 200822040

Release Date: 5/30/08

Legend

Org= Organization name

Org

Address

XX = Date Address = Address

Taxpayer Identification Number:
Form:

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

Dear :

This is a final determination regarding your exempt status under section 501(c)(15) of the Internal Revenue Code (IRC). Recognition of your exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(15) is retroactively revoked to January 1, 20XX because it is determined that you have not established that you are observing the conditions required for the continuation of an exempt status.

We previously provided you a report explaining the proposed revocation of your tax-exempt status. At that time, we informed you of your appeal rights. By signing Form 6018-A, *Consent to Proposed Action*, you indicated that you accept our determination to revoke your organization's exempt status.

We have determined that you fail to qualify for exempt status under any other subsection of IRC 501(c).

You are required to file Federal income tax returns on Form 1120-PC. These returns should be filed with the appropriate Service Center for all years beginning January 1, 20XX. We have secured Form 1120-PC tax returns for the years ended December 31, 20XX, December 31, 20XX and December 31, 20XX.

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.

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations

EXPLANATIONS OF ITEMS

Schedule number or exhibit

Name of taxpayer
ORG

Tax Identification Number

Year/Period ended
12/131/20XX

LEGEND

ORG = Organization name XX = Date XYZ = State Organization = Organization
CO-1 = 1st company CPA = CPA

The corporation 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, of Duty. During the initial inspection of the Form 990 for 20XX, it was noted that the corporation incorrectly reported being exempt under IRC 501(c)(12) on line J in the heading of the return.

On its Form 990 returns filed for the years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX, the corporation reported the following sources of income:¹

	20XX	20XX	20XX
Gifts, Grants and Contributions			
Program Service Revenue			
Membership dues/assessments			
Gross Investment Income			
Other income			
Totals	_____	_____	_____

During the examination of the 20XX Form 990, it was determined that the primary activity of the corporation is to insure property, such as rural buildings, farm personnel, farm equipment, homes, and rural commercial buildings owned by its members. The corporation maintains an office located at Address, City, XYZ. The corporation maintained a staff of approximately six employees at this office location. Staff positions included an office manager, customer service representatives, and an office assistant.

The corporation operates a "self-funded" insurance program that insures property of members within the following 19 counties in the State of XYZ: City, City, City, City, City, City, City, City, City, City, City, City, City, City, City, City, City, and City. The corporation offers a "Mutual Farm Policy" to members, which insures property against damage caused by fire, lightning, explosion, riot, civil commotion, aircraft, vehicles, smoke and/or windstorm, cyclone, tornado and hail.

The corporation requires all purchasers of insurance to complete a formal application process. Each policyholder is considered a member of the corporation, and has one vote at each membership meeting. The corporation charges a \$ policy fee. Premiums are billed by the corporation to policyholders two weeks prior to the due date. Premiums are invested and accumulated until claims are received from policyholders. Per audit, the corporation collected premiums from policyholders in the amount of \$.

A portion of its risks to ceded to CO-1, an unrelated third party insurance company. The corporation ceded reinsurance premiums to CO-1 of \$ in 20XX. Under the terms of the reinsurance agreement, CO-1 reimburses

¹ The sources of income were netted on the 20XX Form 990. Per audit income and expenses were substantially more than that shown on the 990.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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the corporation for all losses in excess of \$ per event. CO-1 is not related to the corporation except through its business relationship.

Claims are reported by policyholders directly to the corporation, and are reviewed by the Secretary-Treasurer whether to assign claims to an independent adjustor. Smaller, less complicated claims are handled through the corporate office. In such cases, the insured is instructed to obtain estimates for the repair and/or replacement of the damaged item(s). Upon receipt of supporting documentation, the payment is processed in accordance with the policy provisions. Larger more complicated claims are assigned to an adjustor, who is sent any documentation (estimates, photos, invoices, etc) that was previously obtained from the insured. The adjustor will, in turn, obtain any additional documentation as needed to properly evaluate the claim. When the amount of the settlement has been determined, all information is sent to the corporation and payment is made. In 20XX, the corporation paid losses of \$.

There is no evidence of any other activities conducted by the corporation.

The examination also revealed that the actual income and expense items shown on the 20XX Form 990, were netted, and thus, did not accurately reflect the financial position of the corporation.

In addition, certain income on the return was reported as "membership dues and assessments," when it actually represented "premiums" collected from policyholders. Such amounts should have been reported as "program service revenue" on the Form 990. Therefore, actual income for tax years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX is summarized below:

	20XX	20XX	20XX
Gifts, Grants and Contributions			
Program Service Revenue:			
Premiums			
Membership dues/assessments			
Gross Investment Income			
Other income			
Totals			

Although the corporation 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, it does not qualify for tax-exempt status under IRC 501(c)(15), for years subsequent to the implementation of the change in requirements, because gross receipts exceeded the \$ limitation allowed by current law.

LAW:

PRIOR LAW

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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, 20XX, the effective date of the Pension Funding Equity Act of 20XX.²

CURRENT LAW

For tax years beginning after December 21, 20XX, 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 \$ 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 \$ 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, 20XX, the new law applies to taxable years beginning after the date such proceeding ends or December 31, 20XX, 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.

² Prior to 1986, the direct or net written premium ceiling was limited to \$5. The Tax Reform Act of 1986 increased the direct or net written premium ceiling to \$350,000 per year.

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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 \$ to \$. 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 20XX, 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 20XX, 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."

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) because its gross receipts for 20XX exceed the \$ limitation 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, because gross receipts exceeded the \$ limitation in those years also.

EXPLANATIONS OF ITEMS

Name of taxpayer
ORG

Tax Identification Number

Year/Period ended
12/131/20XX

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20XX 20XX 20XX

Gifts, Grants and Contributions
Program Service Revenue:
 Premiums
 Membership dues/assessments
Gross Investment Income
Other income
 Totals

Do Gross Receipts exceed the \$ limitation? **YES** **YES** **YES**

50% of Gross Receipts
Premiums Received
Do Premiums exceed 50% of Gross Receipts **YES** **YES** **YES**

Alternative Test

Do Gross Receipts exceed The \$ limitation? **YES** **YES** **YES**

35% of Gross Receipts
Premiums Received
Do Premiums exceed 35% of Gross Receipts **YES** **YES** **YES**

The principal and alternative gross receipts tests consist of two parts. The corporation must satisfy both parts of the \$/50% gross receipts test or the \$/35% alternative test. In this case, the corporation does not meet either the \$ or \$ gross receipts limitation permitted for small insurance companies. Once the corporation failed to \$ and \$ gross receipts limitations, premium percentage component of the principal and alternative tests is moot.

Finally, with respect to the corporation's reporting exemption under IRC 501(c)(12) in the heading of its Form 990 returns, it was concluded that this reporting was done in error. There is no evidence that the corporation's exemption was modified subsequent to the original July 19XX ruling letter granting exemption under IRC 501(c)(15).

Based on the above analysis, it is determined that 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 its gross receipts for each year exceed the limitations imposed by the Pension Fund Equity Act of 20XX.

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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:

The issue was discussed with the corporation's representative, CPA, CPA, during a phone call on September 6, 20XX. After discussion the new requirements for exemption under IRC 501(c)(15) imposed by the Pension Funding Equity Act of 20XX, the CPA verbally concurred that the corporation did not qualify for exemption under IRC 501(c)(15).

CONCLUSION:

- A. ORG is an insurance company pursuant to Subchapter L of the Code for the taxable years 20XX, 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 exceeded the new limitations imposed under IRC 501(c)(15) of the Internal Revenue Code (and related legislation), as described in the Pension Funding Equity Act of 20XX.
- C. Therefore, revocation of the corporation's tax-exempt under IRC 501(c)(15) is proposed, effective January 1, 20XX.
- D. The corporation is required to file income tax returns for calendar years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX.

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ISSUE:

Whether ORG meets the new requirements for tax-exempt status, under IRC 501(c)(15), as described in the Pension Funding Act of 20XX?

FACTS:

The organization was originally incorporated in the State of XYZ, in September 18XX, under the name, Organization, and having thereafter in 19XX, elected to conduct its business under Chapter 145 of the XYZ Acts of 19XX, these Articles of Incorporation and all matters hereafter to be done in connection with this Company are done in accordance with the 19XX Act, and all acts amendatory thereof and supplemental thereto.

Amended Articles of Incorporation were filed with the State of XYZ, Department of Insurance, on May 2, 19XX, changing the name of the organization to ORG, with its principal office located in , XYZ.

The primary purposes of the corporation are as follows:

1. To insure the following kinds of property outside the corporate limits of cities and towns:
 - Farm dwellings and other farm buildings, and the contents of such buildings; farm machinery and other farm equipment; farm products, livestock; schoolhouses, churches; and such other risks as are owned principally by farmers.
2. To make, upon such property, and with the territorial limitations imposed by the 19XX Act, the following kinds of insurance:
 - a. Insurance against loss or damage by fire and extended coverage, including lightening, windstorm, hail and allied lines;
 - b. Insurance against loss or damage, including loss of rents, use and occupancy, caused by fire, smoke, smudge, lightening or other electrical disturbance.
3. To issue policies of reinsurance to other mutual companies operating in this state and to accept policies of reinsurance from other companies, and also to issue policies of insurance jointly with other companies.

Internal Revenue Service records reveal that the corporation was granted exemption as a small insurance company described in section 501(c)(15) of the Internal Revenue Code in July 19XX. Neither the Service nor the corporation has a copy of the corporation's original application for recognition of exemption or the July 19XX favorable ruling letter.

Internal Revenue Service

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

Date: September 26, 2007

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