DEPARTMENT OF THE TREASURY

Internal Revenue Service
TE/GE EO Examinations
1100 Commerce Street
Dallas, TX 75424

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

August 27, 2008

Release Number: **200850040**
Release Date: 12/12/08
LEGEND
ORG = Organization name XX = Date Address = address
UIL:501.15-00

ORG
ADDRESS

Person to Contact:
Identification Number:
Contact Telephone Number:
In Reply Refer to: TE/GE Review Staff
EIN:

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.You properly signed Form 6018-A, Consent to Proposed Action, agreeing to this action.

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.

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. You have properly filed the 1120-PC federal tax returns for the tax period(s) shown above with the Ogden Service Center. 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 yours,

Vicki L. Hansen
Acting, Director EO
Examinations

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 XYZ = State Address = address County = county motto = motto CO-1 = 1st company CPA = CPA

ISSUE:

Whether ORG (hereinafter, the "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:

ORG was originally incorporated in the XYZ, on March 4, 19XX, under the name ORG. The corporation operates under the Laws of the XYZ as enacted by the General Assembly, May 22, 18XX, Chapter , Subject , Section to inclusive General Statutes.

The primary purpose of ORG is to reduce the minimum cost of insurance to members.

The Secretary of State of the of XYZ, certified the Articles of Incorporate, in accordance with , on June 6, 19XX.

Amended Articles of Incorporation were filed with the XYZ, Department of Insurance, on January 22, 19XX, changing the name of ORG to ORG.

ORG also filed an Article of Amendment on April 23, 20XX, again changing the name to ORG, with its principal place of business located in City, County, XYZ. The amendment also changed the membership requirement to add additional member territories of County and County. The primary purpose of ORG remained unchanged from its original purpose. Specifically, ORG is authorized to transact the business of Motto ( ) in the of XYZ.

Internal Revenue Service records reveal that the latest ruling letter issued to ORG Granting exemption under section 501(c)(15) as a small insurance company is dated June 30, 19XX.[1]

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 ORG accurately reported being exempt under IRC 501(c)(15) on line J in the heading of the return.

On its Form 990 return filed for the years ended December 31, 20XX, ORG reported the following sources of income:

20XX

1.

Gifts, Grants and Contributions	$ -0-	
Program Service Revenue		-0-
Membership dues/assessments		
Interest of savings and investments		
Dividends and interest from securities		
Gain from sale of assets		
Other income	-0-	
Totals	$	

During the examination of the 20XX Form 990, it was determined that the primary activity of ORG is to insure property, such as rural buildings, personal residences, farm property, farm equipment, and rural commercial buildings owned by its members. ORG insures such property from losses primarily due to fire, windstorm, theft and vandalism. ORG operates a "self-funded" insurance program that insures property of members in County, County, County, County, County, and County Counties in the XYZ. ORG maintains an office located at Address, City, XYZ. The office is operated by a staff of approximately eight employees. Staff positions included a bookkeeper, clerical support, receptionist, and four insurance agents and adjusters.

ORG 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. Premiums are collected at time of sale of new policies and upon renewal of annual and five year policies. Premiums are invested and accumulated until claims are received from policyholders. During 20XX, ORG earned premium income of $, and insured policies with a total value face of $.

A portion of its risks to ceded to CO-1, an unrelated third party insurance company. Claims are reported by policyholders directly to ORG. ORG assigns claims to an adjuster for investigation and collection of information. When claims are settled, the policyholder is required to execute a "Release and Settlement of Claim," and then funds are disbursed to settle the claim. During 20XX, ORG settled claims for losses due primarily to fire and windstorm in the amount of $. ORG did not recover any of its risk under the Aggregate Excess Loss Reinsurance Agreement with CO-1.

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 accurately reported in total, however, the manner in which that income items was reported did accurately reflect the financial position of ORG.

In particular, 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, as indicated by the instructions to the return for line 2, Part I. Therefore, the actual sources of income for tax year ended December 31, 20XX, is summarized below:

20XX

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

Gifts, Grants and Contributions		$ -0-
Program Service Revenue		
Membership dues/assessments		-0-
Interest of savings and investments		
Dividends and interest from securities		
Gain from sale of		
Other income	-0-	
Totals	$	

Since more than half of its business during the year involved the insuring of insurance or reinsuring of insurance risks, ORG is operated as an insurance company as described in subchapter L of the Internal Revenue Code, However, ORG does not qualify for tax-exempt status under IRC 501(c)(15), for the tax year ended December 31, 20XX, because gross receipts exceeded the $600,000 limitation described in Notice 2006-42 I.R.B. 2006-19, April 24, 2006.

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.[2]

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):

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.

2

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 $300,000. 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.

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."

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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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, 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, more than 50% 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 $600,000 limitation imposed by the new law. Furthermore, the corporation also failed to meet the new requirements for exemption under IRC 501(c)(15) for 20XX, and Form 1120-PC was filed by company on a timely basis. During the audit, gross receipts were calculated based on Notice 2006-42 as follows:

GROSS RECEIPTS:	20XX
Program Service Revenue:	
Assessments	
Premiums	
Survey Fees	
Insurance Tax Fees Retained	
Total Program Service Revenue	
Interest and Dividends	
Gain on sale of Securities	
Gross receipts, per audit/Notice 2006-42	
Do gross receipts exceed the $ limitation?	YES
50% of gross receipts.	
Premiums from insurance.	
Are premiums more than 50% of Gross Receipts?	YES
Do gross receipts exceed the $ limitation?	YES
35% of Gross Receipts.	
Premiums from insurance.	
Are premiums more than 35% of gross receipts?	YES
Qualification/Status	taxable corp
Return Required	1120-PC

The principal and alternative gross receipts tests consist of two parts. ORG must satisfy both parts of the $600,000/50% gross receipts test or the $150,000/35% alternative test. In this case, ORG does not meet either the $600,000 or $150,000 gross receipts limitation permitted for small insurance companies. Once ORG failed to $600,000 and $150,000 gross receipts limitations, premium percentage component of the principal and alternative tests is moot.

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, ORG no longer qualifies for tax-exempt status for the tax year ended December 31, 20XX, because it is not operated as a small insurance company since its gross receipts for the year exceed the limitations 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:

Form 5701, Notice of Proposed Adjustment, was mailed to ORG's representative, CPA, on May 28, 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.

The issue was also discussed with CPA, during a phone call held on June 11, 20XX. CPA verbally agreed that ORG did not qualify for tax-exempt status under IRC 501(c)(15) for the 20XX tax year because its gross receipts exceed the $600,000 limitation described in Notice 2006-42. The Form 5701 will be completed confirming the agreement with the proposed revocation action.

On ____________, the Service received a signed Form 5701 agreeing with the proposed revocation issue described in the preliminary report. The Form 5701 was signed by ______________, CPA, on ____________20XX.

CONCLUSION:

A. ORG is an insurance company pursuant to Subchapter L of the Code for the taxable year ended December 31, 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, as described in the Pension Funding Equity Act of 2004 and Notice 2006-42.

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, Form 1120-PC, for the tax year ended December 31, 20XX.

Internal Revenue Service

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

Date: August 27, 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