



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
Attn: Mandatory Review, MC 4920  
1100 Commerce Street  
Dallas, TX 75242

TAX EXEMPT AND  
GOVERNMENT  
ENTITIES DIVISION

Number: 200903093  
Release Date: 1/16/2009

**Date: October 15, 2008**

LEGEND

UIL: 501.15-00

ORG = Organization name

XX = Date

Address = address

ORG  
ADDRESS

**Employer Identification Number:**  
**Person to Contact / ID Number:**  
**Contact Numbers:**  
**Voice:**  
**Fax:**

**CERTIFIED MAIL – RETURN RECEIPT REQUESTED**

Dear \_\_\_\_\_ :

In a determination letter dated May 10, 20XX, you were held to be exempt from Federal income tax under section 501(c)(15) of the Internal Revenue Code (the Code).

Based on recent information received, we have determined you have not operated in accordance with the provisions of section 501(c)(15) of the Code. Accordingly, your exemption from Federal income tax is revoked effective January 1, 20XX. This is a final adverse determination letter with regard to your status under section 501(c)(15) of the Code.

We previously provided you a report of examination explaining why we believe revocation of your exempt status is necessary. At that time, we informed you of your right to contact the Taxpayer Advocate, as well as your appeal rights. On May 7, 20XX, you signed Form 6018-A, Consent to Proposed Action, agreeing to the revocation of your exempt status under section 501(c)(15) of the Code.

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 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 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 contact the person whose name and telephone number are shown at the beginning of this letter.

Sincerely,

Vickie L Hansen  
Acting Director, EO Examinations

Encl: Form 6018-A

**Internal Revenue Service**

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

Date: April 23, 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 <b>886-A</b> (Rev. January 1994)	<b>EXPLANATIONS OF ITEMS</b>	Schedule number or exhibit
Name of taxpayer <b>ORG</b>	Tax Identification Number	Year/Period ended <b>12/31/20XX</b> <b>12/31/20XX</b>

**LEGEND**

ORG = Organization name      XX = Date      City = city      XYZ = State      BM-1, BM-2, BM-3 & BM-4 = 1<sup>ST</sup>, 2<sup>ND</sup>, 3<sup>RD</sup> & 4<sup>TH</sup> Board Members      CO-1, CO-2, CO-3, CO-4 & CO-5 = 1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>rd</sup>, 4<sup>th</sup>, & 5<sup>th</sup> Companies.

**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 February 14, 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(2) of the Ordinance. The liability of members is limited. The corporation is authorized to issue shares of \$ per share. The corporation actually issued shares. The shares are owned equally by four shareholders, BM-1, BM-2, BM-3, and BM-4. Each shareholder owns shares or 25% ownership interest in the corporation.

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

ORG filed an election under Internal Revenue Code section 953(d) to be treated as a domestic corporation for United States tax purposes. The election was accepted by the Service, and commenced on February 14, 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 May 10, 20XX, commencing February 14, 20XX for all tax years beginning before January 1, 20XX, when net written premiums (or, if greater, direct written premiums) do not exceed \$. For tax years beginning on or after January 1, 20XX, the corporation is exempt if (a) gross receipts for the taxable year do not exceed \$\$, and (b) more than 50 percent of the gross receipts for the taxable year consist of premiums.

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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, 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.

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	-0-	-0-
Gain of Sale of Assets	-0-	-0-
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 vehicle service contract, with CO-2 and CO-3 as the direct writer and administrator. The corporation is owned by four equal shareholders. The shareholders are long time business operators in the automotive industry and operate two automobile dealerships located in the City, XYZ area. The dealerships with which ORG is affiliated are called CO-4. The dealerships were the source of the risk that was eventually reinsured by ORG.

In 20XX, ORG began to cease accepting new business and went into run-off as a reinsurance company. Its sole purpose at that point was to pay claims on the variety of risks reinsured with the company and to make reimbursements for any policies cancelled by the consumer. ORG engaged in only minimal reinsurance business in 20XX. ORG received only \$ premium income in 20XX. The last year that ORG had positive premiums cash flow was 20XX.

During the 20XX tax year, ORG did not receive premiums from insurance or reinsurance business. ORG ceased operations and went into run-off status in 20XX. ORG provided for the reimbursements of premiums in the amount of \$, for the cancellation of the vehicle service contracts by customers of the auto dealerships. ORG reported gross receipts of \$ and \$ for 20XX and 20XX, respectively.

ORG's gross receipts consisted primarily of interest earned on its temporary savings. There is no evidence of any notes executed with related parties. The corporation reported gross investment income of \$ in 20XX, and \$ in 20XX.

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ORG's gross receipts are less than the \$\$ limitation imposed by the Pension Funding Equity Act of 2004. However, based on the sources of receipts reported on the 20XX and 20XX Form 990 returns, the premium income was not "more than 50%" of the corporation's gross receipts.

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

At the end of 20XX, ORG had reserves of approximately \$ in cash. Unearned premiums totaled \$ as of December 31, 20XX.

It is expected that the reserves will be depleted by the end of 20XX. The corporation plans to file a final return for the 20XX tax year.

Although ORG was in "run-off" status in 20XX and 20XX, the corporation is deemed to be an insurance company under Subchapter L of the Internal Revenue Code. However, ORG does not qualify for tax-exempt status under IRC 501(c)(15), for the 20XX and 20XX tax years, because it failed to meet the new requirements for tax-exempt status as described in the Pension Funding Equity Act of 20XX.

#### **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 \$ 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 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

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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:

**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.<sup>1</sup>

**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):<sup>2</sup>

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).

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.

<sup>1</sup> 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.

<sup>2</sup> Notice 2006-42, I.R.B. 2006-19, April 24, 2006.



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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 can 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, 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), in 20XX and 20XX, because its gross receipts do not consists of adequate "premiums" to meet the 50% test imposed by the new law. During the 20XX, ORG received only very minimal premium income, while for 20XX it did not receive any premiums. On the Form 990 returns, ORG reported premiums of only (\$) in 20XX, and (-\$) in 20XX, which represented reimbursement of premiums to consumers for cancellation of the vehicle service contracts. The reimbursements in 20XX were reported on the return as a negative income item instead of reporting such reimbursements as an expense item. Based on the audit, ORG's gross receipts for 20XX and 20XX are as follows:

	20XX	20XX
Premiums		
Interest on temporary savings		
Dividends and interest from securities	-0-	-0-
Other income	<u>-0-</u>	<u>-0-</u>
Gross Receipts		

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

No

No

50% of Gross Receipts  
Premiums

**Do Premiums exceed 50%  
Of Gross Receipts?**

No

No

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**Does Org meet the Gross Receipts Test?**

No

No

**Does Org Qualify for exemption Under IRC 501(c)(15)?**

No

No

**Conclusion**

1120PC

1120PC

**NOTE: As a stock corporation, the alternative gross receipts test (\$/35%) is NOT available to ORG. Such alternative test is available to mutual insurance companies only.**

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 component of the two part test, then it fails to qualify for exemption as a small insurance company. **Note: As a stock corporation, the alternative gross receipts test (\$150,000/35%) 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 Funding 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 representative, Attorney, with CO-5, during a telephone call held on March 13, 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.

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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 years ended December 31, 20XX and December 31, 20XX.