



**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: **200919051**
Release Date: 5/8/2009

Date: January 29, 2009

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 October 14, 19XX, 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 March 26, 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 years ended December 31, 20XX, December 31, 20XX, and December 31, 2007, 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,

Renee B Wells
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: March 14, 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 Address = address City = city XYZ = State
 ORG-1 = 1st organization ORG-2 = 2nd organization ORG-3 = 3rd organization
 CPA = CPA CO-1 = 1st company

ISSUE:

Whether 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:

The organization, originally known as the ORG-1, was formed as an association in the State of XYZ in 18XX, to serve as a mutual fire insurance company. In 19XX, the association changed its name to ORG-2. The org continued operations as an association until 19XX. The org officially incorporated in the State of XYZ, on August 15, 19XX, under the name ORG-3. The organization's name was changed to its current name, ORG, on January 30, 19XX.

The purpose of ORG (hereinafter "Corporation") is to insure members against loss from hazards permitted to be insured against by the farm mutual law under which it operates and to distribute on the mutual insurance plan such loss as may occur in spite of reasonable precautions.

The Corporation is not authorized to issue shares of capital stock. The Corporation is governed by a board composed of no more than ten directors. Membership in the corporation consists of all persons or organizations having insurance therein. Membership and insurance is obtained only upon written application signed by the applicant and approved by the Secretary of board.

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 on October 14, 19XX, effective for all tax years subsequent to December 31, 19XX, when net written premiums (or, if greater, direct written premiums) do not exceed \$\$.

The Corporation is required to file annual information return, Form 990, and employment tax returns Forms 941 and 940. The Form 990 returns filed for the year ended December 31, 20XX, and December 31, 20XX was examined by TE/GE, City Post of Duty. During the initial inspection of the returns, it was noted that the corporation accurately reported being exempt under IRC 501(c)(15) on line J in the heading of both returns.

Since the passage of the Pension Funding Equity Act of 2004, the Corporation filed Form 990 returns for tax years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX. On its Form 990 returns, the Corporation reported the following sources of income:

	20XX	20XX	20XX
Gifts, Grants and Contributions	-0-	-0-	-0-

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Program Service Revenue	-0-	-0-	-0-
Membership dues/assessments	-0-	-0-	
Interest on savings			
Gross rents			
Other income:			
Premiums -- Insurance			
Premiums- Liab. & Equity			
Reimbursements			
Recovery Insurance			
Total Revenue	\$	—	

During the examination of the 20XX and 20XX Form 990 returns, it was determined that the primary activity of the Corporation is to provide property insurance against losses due to fire and windstorm to farmers, homeowners and dwelling owners throughout various counties in the State of XYZ. Liability coverages are written with 100% of the liability risks ceded to CO-1. Under the reinsurance agreement, the Corporation is reimbursed for aggregate net losses due to fire that exceed an attachment point specified in the agreement. The Corporation wrote policies with a gross fire risks-in-force exceeding \$ dollars.

The Corporation is located at Address, City, XYZ. The office is manned by four employees whose duties include handling all underwriting of insurance policies, accounting functions, administration of policies, claims administration and claims payments.

In 20XX and 20XX, the primary source of receipts for the Corporation was premiums from policyholders. The premiums are reported on the Form 990 returns as "other income." In Part VII of the 20XX Form 990, the Corporation reported gross premiums of \$, while in 20XX, gross premiums were reported in the amount \$. Additional sources of gross receipts included membership assessments, interest on temporary savings and Certificate of Deposits, and rental income. The Corporation also reported amounts reimbursed by its reinsurer, CO-1, as gross receipts. For 20XX, the reinsurance recovery amount is \$. The corporation did not receive any reimbursements from the reinsurer in 20XX.

The Corporation expenses included payment of insurance losses to policyholders. Losses due to fire and wind claims were reportedly paid in the amount of \$ in 20XX and \$ in 20XX.

There is no evidence of any other significant activities conducted by the Corporation during the years under examination.

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, the Corporation does not qualify for tax-exempt status under IRC 501(c)(15), for years subsequent to the passage of the Pension Funding Equity Act of 2004, because it failed to meet the new requirements for tax-exempt status. Gross receipts, as reported for the 20XX and 20XX tax years, exceeded the \$ limitation imposed by the Pension Funding Equity Act of 2004.

LAW:

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

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):

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.

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

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.

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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 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, 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 exceed the \$\$\$ limitation imposed by the Pension Funding Equity Act of 2004 and Notice 2006-42 L.R.B. 2006-19, April 24, 2006. For continued

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qualification for tax-exempt status under IRC 501(c)(15), the Corporation must meet the following two-part test:

1. Gross receipts for the year may not exceed \$ and
2. Premiums must be more than 50% of the organization's total gross receipts.

The gross receipts as reported on the 20XX and 20XX Form 990 returns clearly exceed the \$ limitation. However, a gross receipts determination was made, during the examination, based on the guidelines described in Notice 2006-42. Under Notice 2006-42, certain amounts are excluded from the gross receipts. Section 3 of Notice 2006-42 includes the following language:

Gross receipts do not 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 section 118, or salvage or reinsurance recovered accounted for as offsets to losses incurred under section 832(b)(5)(a)(i).

Based on the above language the determination of gross receipts for 20XX and 20XX was recalculated as follows:

	20XX	20XX
Gifts, Grants and Contributions	\$ -0-	\$ -0-
Program Service Revenue:		
Premiums – Insurance		
Premiums- Liab. & Equity		
Membership dues/assessments	-0-	
Interest on savings		
Gross rents		
Other income		
Gross Receipts	\$	
Do Gross Receipts exceed the \$\$ limitation?	YES	YES
50% of Gross Receipts	\$	
Premiums Received	\$	
Do Premiums exceed 50% of Gross Receipts?	YES	YES

ALTERNATIVE TEST

Do Gross Receipts exceed the \$\$ limitation?	YES	YES
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35% of Gross Receipts \$

Premiums Received \$

Do Premiums exceed 35% of Gross Receipts? 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, ORG does not meet part-one of either the \$\$/50% or the \$\$/35% gross receipts tests since its gross receipts exceed the \$\$ limitation. ORG does meet part-two of each test. However, in order to qualify for tax-exempt status under IRC 501(c)(15), the organization must satisfy both parts of either two-part gross receipts test. If ORG fails to meet one-part of either test, then it fails to qualify for exemption as a small insurance company.

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 tax years subsequent to the passage of 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.²

TAXPAYER'S POSITION:

Form 5701, Notice of Proposed Adjustment, was mailed to the organization's representative, CPA, CPA, on February 27, 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.

On March 13, 20XX, 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 March 8, 20XX.

CONCLUSION:

- A. ORG is an insurance company pursuant to Subchapter L of the Code for the taxable years 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 exceed the \$\$ and \$\$ limitations imposed under Notice 20XX-42 required for qualification of tax-exempt status under IRC 501(c)(15) of the Internal Revenue Code.
- C. Therefore, revocation of the ORG's tax-exempt under IRC 501(c)(15) is proposed, effective January 1, 20XX.

² Due to statute considerations, the 20XX tax year is not part of the audit.

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D. ORG is required to file income tax returns for calendar years ended December 31, 20XX and December 31, 20XX.