Internal Revenue Service

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

Release Number: **200836038**
Release Date: 9/5/08
Date: October 24, 2007
UIL Code: 501.15-01
Legend
ORG = Organization name
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 12/131/20XX

LEGEND
ORG = Organization name XYZ = State City = city XX = Date President = president Vice President = vice president Board Family = board family BM-1, BM-2, BM-3 = 1st, 2nd, & 3rd board members 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 received a Certificate of Authority, to operate as a vehicle mechanical breakdown insurer in the State of XYZ, from the Commissioner of Insurance, on March 7, 19XX.

The organization incorporated in the State of XYZ, on April 17, 19XX, under the name, ORG, under the XYZ Business Corporation Law.

ORG (hereinafter "ORG") is formed to engage in any lawful activity for which corporations can be formed under the XYZ Business Corporation Law. The initial incorporator of ORG was President.

ORG is authorized to issue shares of capital stock having no par value per share. The initial shares were purchased by President (shares) and Vice President (shares) on March 9, 19XX, for an initial capital contribution of $. President and Vice President are father and son, respectively.

ORG was initially governed by a three member Board of Directors, although clause II of the Bylaws authorizes only two directors. The initial directors included President, Vice President, and BM-1. During the year under audit, members of the Board Family (Vice President and BM-2, brother and sister) held all director and officer positions of ORG.[1]

ORG applied for and received a license from the State of XYZ, Commissioner of Insurance, in May 19XX, to operate as a vehicle mechanical breakdown insurer pursuant to provisions of Title of the XYZ Revised Statute of 19XX, as amended by Act of 19XX ( ). Under state law, ORG is required to pledge securities valued at $ with the Insurance Commissioner, to assure faithful performance of its obligations to policyholders.

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 April 28, 19XX, commencing January 1, 19XX for all tax years when net written premiums (or, if greater, direct written premiums) do not exceed $.

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

[1] President, father, deceased as of January 1, 20XX.

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, and December 31, 20XX. ORG did not claim to be an exempt entity for 20XX, and filed Form 1120, as a taxable entity. 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		
Program Service Revenue		
Membership dues/assessments		
Interest on savings		
Other income		
Totals		

During the examination of the 20XX Form 990, it was determined that the primary activity of ORG is to issue vehicle mechanical breakdown insurance policies. ORG sold mechanical breakdown vehicle service contracts to purchasers of new vehicles from CO-1 (dba CO-1) and II CO-1 (dba CO-1). Both dealerships are located in XYZ and are primarily owned and controlled by shareholders of ORG. President was the principal owner of CO-1 (%) until his death in January 20XX. After his death, ownership of CO-1 was comprised as follows:

Vice President
BM-2
BM-3
Six Grandchildren
BM-3 Testamentary Trust
Total ownership

CO-1 started operations in , and is solely owned by Board Family members, Vice President (%) and BM-2 (%).

ORG sold vehicle service insurance policies between the period of April 19XX, through August 19XX. ORG has been is "run-off" status since August 19XX.

Each time a new vehicle was sold by the dealerships, a vehicle service insurance policy was offered to the customer. Customers could purchase basis ORG Custom Coverage, or the optional Custom Plus Coverage. Coverage could be purchased anytime within the first 12 months of the vehicle purchase. Coverage could be acquired based on mileage limits (60,000 to 100,000 miles) or a specific period of extended coverage (5 to 6 years). Both dealerships used the same vehicle service insurance policy.

Customers could also purchase vehicle service insurance policies from companies not affiliated with ORG, upon request.

No written agreements exist between ORG and the dealerships. On an annual basis, ORG shareholders established the policy premium charge to the dealerships. The premiums were set based on experience and competitive costs of other companies. The amount of the premium charged to customers was not fixed. Therefore, the dealership's profit margin could fluctuate, whereas the ORG premium could not. The premium rate charged to the dealerships was based on the vehicle and extent of coverage. The dealership's profit margin ranged from $ to $, with the average profit margin being $ to $. For all policies written, the dealerships retained a commission, and remitted the balance to ORG.

As premiums were received by ORG, the amounts were recorded as "Unearned Premium Reserve" and are amortized annually as earned. In 20XX, ORG reported premium income $, which represented recognition of amounts recorded as unearned premium reserves in prior years.

Additional sources of gross receipts consisted of interest on its savings account ($); interest on Certificate of Deposits ($); interest on Notes Receivable Due from Affiliates ($), interest on IRS Refund ($), and a state tax refund of ($). ORG is 100% responsible for all claims. None of ORG's risk is retroceded to other reinsurance companies. ORG paid minimal claims of $ in 20XX.

Effective August 19XX, ORG discontinued writing policies. Between April 19XX, and August 19XX, ORG issued vehicle mechanical breakdown policies insuring vehicles sold by CO-1 and CO-1. ORG ceased issuing policies because the owners reached the conclusion that the volume of new policies being issued by ORG was not sufficient. ORG has been in "run-off" since August 19XX, and all policies have matured as of July 31, 20XX. ORG did not engage in insurance operations in 20XX. In 20XX, ORG initiated steps to dissolve the corporation.

ORG's gross receipts are less than the $ limitation imposed by the Pension Funding Equity Act of 2004. However, based on the data reported on the 20XX Form 990, the amount of premiums did not meet the 50% of gross receipts test.

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

Although ORG was is "run-off" status in 20XX, the corporation is operated as an insurance company, since more than half of its business during the year involved the insuring or reinsuring of insurance risks. However, ORG does not qualify for tax-exempt status under IRC 501(c)(15), for the 20XX tax year, subsequent to the passage of the Pension Funding Equity Act of 2004, because it failed to meet the new requirements for tax-exempt status.

LAW:

PRIOR LAW

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer ORG		Tax Identification Number	Year/Period ended 12/131/20XX

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 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 $150,000 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, 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.

[2] 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.

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 $350,000. 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 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."

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, 50% or more must be derived from premium income.

The facts present in this case, clearly demonstrate that the ORG does not meet the new requirements for tax-exempt status under IRC 501(c)(15), in 20XX, because its gross receipts do not consists of adequate "premiums" to meet the 50% test imposed by the new law. However, ORG did meet the new requirements for exemption under IRC 501(c)(15) for tax year ended December 31, 20XX. Based on the audit, ORG's gross receipts are as follows:

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number	Year/Period ended 12/131/20XX

	20XX	20XX
Gifts, Grants and Contributions		
Program Service Revenue: Premium		
Membership dues/assessments		
Interest on savings		
Interest on Notes Receivable		
Misc interest		
Other income		
Totals		
Do Gross Receipts exceed the $ limitation?	**No**	**No**
50% of Gross Receipts		
Premiums Received		
Do Premiums exceed 50% of Gross Receipts?	**Yes**	**No**

The principal gross receipts tests consist of two parts. The corporation must satisfy both parts of the $600,000/50% gross receipts test. In this case, ORG does meet part-one of the $600,000 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. ORG must satisfy both parts of the $600,000/50% gross receipts test in order to meet the new requirements for tax-exempt status under section 501(c)(15) of the Code. If the Commission fails to meet one part of either test, then it fails to qualify for exemption as a small insurance company. 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 was 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, because it is not operated as a small insurance company since it fails to comply with the $600,000/50% gross receipts test imposed by the Pension Fund Equity Act of 20XX.

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, CPA, on October 4, 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.

CONCLUSION:

A. ORG is an insurance company pursuant to Subchapter L of the Code for the taxable years 20XX, 20XX, and 20XX.

B. Although the 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 $600,000/50% gross receipts test imposed under IRC 501(c)(15) of the Internal Revenue Code (and related legislation), as described in the Pension Funding Equity Act of 2004.

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 year ended December 31, 20XX.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE
1100 Commerce St. – 4920 DAL
Dallas, TX 75242

UIL: 501.15-00

LEGEND
ORG = Organization name XX = Date Address = address

ORG
ADDRESS

Taxpayer Identification Number:
Form:
Tax Year(s) Ended:
Contact/ID Number:
Contact Numbers:
Telephone

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

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.

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 as described in Publications 892.

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, 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 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

Enclosure
Publication 892