



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
TE/GE Division

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Org

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 an adjustment 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 modifying or revoking 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:

Internal Revenue Service
Office of the Taxpayer Advocate
Local Office

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,

Rosie C. Johnson
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Form 6018
Report of Examination
Envelope

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

LEGEND

ORG = Organization name XX = Date BM-1 = 1st board member BM-2 = 2nd board member BM-3 = 3rd board member Attorney = attorney
Program = Program City = city CO-1 = 1st company CO-2 = 2nd company
CO-3 = 3rd company CO-4 = 4th company CPA = CPA TLS = TLS

I. ISSUES:

A. Is ORG, ("ORG"), an insurance company exempt from tax pursuant to I.R.C. § 501(c)(15) for the taxable years 20XX and 20XX?

1. Definition of an Insurance Company

ORG Failed to Use its Capital and Efforts Primarily to Earn Income from its Insurance Activity

2. ORG Was Not Issuing Insurance Contracts or Reinsuring the Risks of Others During 20XX and 20XX

i. Warranty Repair/Replacement Insurance

B. Does ORG, a foreign company which made an election under I.R.C. § 953(d), continue to qualify for exemption from federal income tax as an organization described in I.R.C. § 501(c)(15)?

1. ORG Is Not Described in Section 501(c)(15) During the Years Under Exam

2. ORG Cannot Rely on Its Determination Letter

3. Section 7805(b) Relief

II. FACTS:

A. ORG' Income Statement

ORG reported the following on its Income Statement for the taxable years 20XX, 20XX, and 20XX¹:

	20XX	20XX	20XX
Sum			
Receipts			
Premiums Earned	\$	\$	\$

* * * *

¹ Financial information for 20XX is provided for background and historical purposes only.

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Interest Income	-0-	\$	\$	\$
Gross Amt from Sales	-0-	-0-	\$	\$
Less Cost Basis	-0-	-0-	(\$)	(\$)
Less equity earnings	-0-	-0-	\$	\$
Miscellaneous Income	-0-	-0-	-0-	-0-
Total Revenue	\$	\$	\$	\$
Percentage Premiums	%	%	%	%

Expenses				
Accounting	\$	\$	\$	\$
Formation Cost		\$	-0-	\$
Travel	\$	-0-	-0-	\$
Interest and Bank Charges	\$	\$	\$	\$
Policy administration	\$	\$	\$	\$
Other expenses	\$	\$	\$	\$
Total expenses	\$	\$	\$	\$

B. ORG' Balance Sheet

ORG reported the following on its Balance Sheets for the taxable years 20XX, 20XX, and 20XX.

	20XX	20XX	20XX
Assets			
Cash in checking	-0-	\$ \$	\$
Cash in Savings	\$	-0-	-0-
Notes/Loan Receivable	-0-	-0-	\$
Investments in Securities	-0-	\$	\$
Premium Receivable	-0-	\$	-0-
Total Assets	\$	\$	\$
Liabilities			
Bank Overpayment	-0-	\$	\$ -0-
Accounts Payable	-0-	\$	\$
Related Party Payables	-0-	\$	\$
Total Liabilities	-0-	\$	\$
Net Worth			
Capital Stock	\$	\$	\$
Paid in Capital	-0-	\$	\$
Retained Earnings	\$	\$	\$
Total Fund Balance	\$	\$	\$
Total Liab. & Net Worth	\$	\$	\$

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C. ORG's Form 990

ORG filed a Return of an Organization Exempt from Income Tax (Form 990) for the taxable years 19XX, 20XX, 20XX, and 20XX. ORG filed Form 1120 for 20XX. On its Forms 990, ORG reported premium income of \$, \$ in 20XX and 20XX, respectively, related to its I.R.C. §501(c)(15) tax-exempt status.

As a result of its tax-exempt status, net income from passive sources totaling \$ in 20XX and (\$) in 20XX was not subject to income tax pursuant to I.R.C. § 512(b)(1) and/or I.R.C. § 501(a).

D. Organization:

ORG. ("ORG") is owned by three individual shareholders, BM-1 and BM-2, husband and wife, each own a % interest of ORG. BM-3, sister of BM-2, owns the remaining % interest. ORG was formed in October 19XX, as a Country company that elected to be treated as a U.S. entity pursuant to I.R.C. § 953(d).

ORG had less than \$ in net premiums per year, and therefore qualified as a tax-exempt insurance company pursuant to I.R.C. § 501(c)(15). The IRS issued a Determination Letter to ORG on January 30, 20XX, granting ORG tax-exempt status.

E. Implementation of the Insurance Strategy

Attorney, Attorney, promoted the PROGRAM to the shareholders of ORG. A promotional package entitled, "Alternative Risk Mechanisms – Offshore Insurance Companies (PROGRAM)" was developed by Attorney specifically for presentation to BM-1. Attorney made the presentation in June 19XX. The promotional materials included a letter dated June 16, 19XX, from Attorney to BM-1. The letter represented the Fee Agreement For Legal and Consulting Services between the parties.² The agreement described the scope of Attorney's services as follows:

Generally, I have been requested to represent you and provide specific counsel as to the implementation, formation and creation of a captive insurance program in the Country. In addition to the above, I will also provide counsel during the first operating year of any insurance company formed for such purpose.

* * * *

² The agreement included in the promotional material was signed by Attorney only. Although the agreement does not include BM-1's signature, subsequent faxes between parties shows that the terms were agreed and accepted by BM-1.

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Specifically, my efforts will be devoted toward creating a PROGRAM suitable to your needs. I will design the program, create all supporting forms and documents, form an insurance company in a suitable domicile and put the program into full operation. However, my services do not extend to the tax qualifications or filings necessary to perfect the insurance company's tax exempt status (which I understand will be the task of your chosen accountant); nor, do I warrant or guarantee the economic viability of the insurance company or its program, which may be subject to the vagaries of the underlying activities of an associated program. All counsel or advice as to the ramifications of federal or state tax law, statutes or regulations shall be the responsibility of your chosen accountant or tax advisor.

My services in this matter will be billed to you at a flat rate of \$ plus costs of travel, lodging and expenses incurred in my work on this matter.

Subsequent discussions between Attorney and BM-1 took place by fax transmissions. In a fax dated August 27, 19XX, Attorney informed BM-1 that ORG's insurance application was approved in CO-1. Attorney organized business meetings with several clients, including BM-1, which took place on City, Country, during the week of October 18, 19XX. The purpose of the business meeting was to finalize the insurance filings with authorities and to take possession of the insurance policy.

CO-2 (City) sent an Engagement Letter to BM-1 on December 15, 19XX. CO-2 duties included filing the IRC 953(d) election, completing the Form 1024 application form and preparing the initial Form 990 return for ORG.

ORG does not have a formal business plan. According to the minutes of the 19XX Annual Director's meeting, held in December 19XX, ORG would cease to write Warranty Insurance Coverage and would instead insure the following exposures on CO-2:

Professional Indemnity
Computer Breakdown Damage & Business Interruption
Deductible Reimbursement Program

In its November 24, 20XX response to Information Document Request # 4, Attorney indicated that during years 19XX through 20XX, the Warranty Repairs policy was the only policy sold by ORG. In addition, the policy incorporates all three lines business approved by the board in the December 19XX minutes.

F. Capital Structure of ORG

ORG was capitalized in 19XX with \$\$ in cash by its shareholders BM-1, BM-2 and BM-3. BM-1 and BM-2, husband and wife, each own % interest of ORG. The remaining % interest is owned by BM-3, sister of BM-2.

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In addition to their ownership in ORG, BM-1 and BM-2 are equal co-owners of the CO-2, a real estate consulting firm, which is the sole policyholder of ORG. The shareholders contributed additional paid in capital of \$ in 20XX.

Checks from the CO-2 were used to make the initial and additional capital contributions. The shareholders did not contribute appreciated assets to ORG from its inception through the end of the year under audit.

As of December 31, 20XX, ORG reported capital stock of \$\$ and paid-in capital of \$\$\$. ORG reported no loss reserves for 20XX. Note 2(b) of the 19XX Financial Statement states the following:

Policies written provide for coverage on a claims-made basis. Up to the date of the approval of these financial statements, no claims have been received. The Company has not made a reserve for policy losses and related expenses to be determined, the net amounts that will ultimately be paid to settle any liability are not presently determinable.

The shareholders did not contribute additional capital to ORG in 20XX.

G. Employees and Officers of ORG

ORG had no employees during 20XX and 20XX. ORG did not pay a salary to its officers for 20XX and 20XX, as reflected on ORG' Forms 990 for each of the years. Instead, ORG' officers were paid as employees of CO-2

CO-3 ("CO-3") provided insurance management services for ORG, including interfacing with the insurance regulators in the Country and the handling of correspondence sent to ORG. The effective date of the contract was October 26, 19XX. ORG paid only minimal management fees during 20XX and 20XX.

H. ORG' Insurance Activity for 20XX and 20XX

ORG was formed on October 8, 19XX, in the Country. BM-1 formed the company for the purpose of providing warranty insurance to a primary company, CO-2 (CO-2), which is co-owned by BM-1 and his wife, BM-2.

The initial insurance policy (Policy Number) was executed between ORG and CO-2 on November 1, 19XX. For 19XX, the policy was in effect from November 1, 19XX, to December 31, 19XX. CO-2 incurred an insurance premium liability of \$ to ORG for the short year. The premium income was recorded as an Accounts Receivable balance on the books of ORG.

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Under the terms of the policy, ORG agreed to indemnify valid Certificate Holders only in the event repairs or replacement under CO-2's then prevailing express warranties are performed by a party other than CO-2, as a result of CO-2's inability to so perform due to CO-2's insolvency, liquidation or assignment for the benefit of creditors, or as a result of an act of God.

ORG's liability under the policy is limited to \$\$ per claim up to an aggregate of \$.³ The policy is renewal on an annual basis upon payment of the deposit premium equal to % of prior year's audited premium. The policy with CO-2 was renewed for tax years 20XX and 20XX.

In 20XX, the terms of the policy remained primarily unchanged. The terms of the policy were modified to increase ORG's aggregate liability from \$ to \$. CO-2 was liable for premiums of \$ to ORG during the year. ORG received premium cash payment of \$ and the balance of \$\$ was established on ORG's books as a receivable.

ORG sold no other insurance policies during the year. ORG incurred no claims. Nor did ORG establish any loss reserves for potential future claims. ORG incurred minimal operating costs for the year. ORG used its net proceeds to invest in securities. During the year, ORG purchased investments with a fair market value of \$ \$.

The policy with CO-2 was renewed for year 20XX. ORG received premiums of \$ for year 20XX. Premiums were paid by the insured, CO-2. Although the CO-2 is the insured, the coverage benefited its customers in the event of CO-2's insolvency. For each year, a new Declaration page was executed between the parties outlining the renewed terms of the warranty repairs and replacement policy. As was the case in 20XX, ORG incurred no claims during the 20XX year, because none of the events that caused the coverage to start occurred. No other insurance policies were sold by ORG since its inception in 19XX. ORG did not file Form 990 as a tax-exempt insurance company for 20XX.

I. Application for 501(c)(15) Exemption

On September 25, 20XX, ORG sent the IRS in City, XYZ, a Form 1024, Application for Recognition of Exemption under section 501(a) (with Form 2848 and 8821 attached). Attached to the Form 1024 application was a document (2 pages) entitled ORG., CO-4 under Section 953(d), and Form 990 for 19XX (11 pages). The Form 1024 included signed Memorandum of Association (3 pages) and Articles of Incorporation (13 pages) of ORG. Also submitted with the application was a Form 8718, User Fee for Exempt Organization Determination Letter Request (1 page).

* * * *

³ Aggregate liability increased to \$ per resolution passed by board of directors on 12/22/

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The Internal Revenue Service reviewed the application and in a letter dated October 17, 20XX, advised ORG its application was referred to the Assistant Commissioner, Internal Revenue Service.

In a letter dated October 25, 20XX, the Service requested additional information from ORG (2 pages). CPA with CO-2, sent letters dated November 16, 20XX and January 4, 20XX, to TLS, confirming extensions to respond to December 25, 20XX and January 25, 20XX, respective. CO-2 submitted the response on behalf of ORG on January 3, 20XX. The January 3, 20XX letter consisted of a two page cover letter and three exhibits: Exhibit 1--A copy of the insurance policy with CO-2 (4 pages); Exhibit 2--A copy of the 19XX Financial Statements (1 page); and Exhibit 3--A copy of the Section 953(d) election.

On January 30, 20XX, the Service issued ORG a determination letter granting ORG exempt status as an I.R.C. section 501(c)(15) organization (3 pages). These documents, which were exchanged by the parties during the application process and which comprise the administrative record, formed the basis for the determination.

Aside from the documents identified in the above paragraph, no other documents were exchanged during the exemption application process.

The Form 1024 Application provided actual financial information for the short tax year of October 8, 19XX, through December 31, 19XX only. No proposed budgets for 20XX and 20XX were included with the application. The application showed ORG received insurance premiums of \$ in 19XX. No investment income was earned during the short tax year. No other revenue was reported in 19XX. The Form 1024 application reported total assets of \$ from cash and accounts receivable for 19XX. No physical assets were reported on the application for the short tax year.

ORG filed Forms 990 for the years 20XX and 20XX. ORG did not report any changes in operation on Form 990 filed with the Internal Revenue Service for the years 20XX and 20XX.

ORG did not submit additional documents or otherwise provide notice to the Internal Revenue Service of changes in operations subsequent to the issuance of the January 30, 20XX determinations ruling letter.

III. LAW AND ANALYSIS:

Is ORG an Insurance Company Exempt From Tax Pursuant to I.R.C. § 501(c)(15) for the Taxable Years 20XX and 20XX?

The first issue is whether ORG is an insurance company exempt from tax pursuant to I.R.C. § 501(c)(15) for the taxable years 20XX and 20XX. I.R.C. § 501 provides that certain entities are exempt from taxation. Included in these entities are "[i]nsurance companies or associations other

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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 \$." I.R.C. § 501(c)(15)(A).⁴

1. Definition of an Insurance Company.

Neither I.R.C. § 501(c)(15) nor its corresponding regulations define an "insurance company." Subchapter L of the Code (I.R.C. §§ 801-848), however, addresses the taxation of insurance companies. The term "insurance company" has the same meaning under section 501(c)(15) as it does in Subchapter L. See H. Conf. Rep. No. 99-841, 99th Cong., 2nd Sess. (Vol. II) 370-71, reprinted in 1986-3 (Vol.4) C.B. 370-71.

I.R.C. § 816 (formerly I.R.C. § 801) defines a life insurance company. As part of this definition, I.R.C. § 816 provides, the term 'insurance company' means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies."

Treas. Reg. § 1.801-3(a)(1) defines an insurance company as,

A company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

Treas. Reg. § 1.801-3(a)(1)(emphasis added). See also, Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932).

The IRS has not ruled on whether the more stringent "greater than half" test set forth in I.R.C. § 816 applies to an insurance company other than a life insurance company. Instead, to determine whether a non-life insurance company qualifies as an insurance company for tax purposes, the "primary and predominant business activity" test set forth in Treas. Reg. § 1.801-3(a)(1) applies. See Rev. Rul. 68-27, 1968-1 C.B. 315.

* * * *

⁴ 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). I.R.C. § 501(c)(15)(B). Here, ORG is not part of a consolidated group during 20XX and 20XX. Therefore, there are no other premiums to aggregate with the premiums ORG received during 20XX and 20XX, pursuant to I.R.C. § 501(c)(15)(B).

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The courts and the IRS have also, at times, looked to whether the transaction has characteristics traditionally associated with insurance, and whether the company conducts business like an insurance company. In order for ORG to be considered an "insurance company" entitled to tax exempt status under I.R.C. § 501(c)(15) for the taxable years 20XX and 20XX, its primary and predominant business activity during the years must have been issuing insurance contracts or reinsuring insurance risks. See I.R.C. § 816; Treas. Reg. § 1.801-3(a)(1).

2. ORG was Not Issuing Insurance Contracts or Reinsuring the Risks of Others During 20XX and 20XX.

Neither the Internal Revenue Code nor the regulations specifically define the term insurance contract. The courts have generally required that a transaction involve both risk shifting (from the insured's perspective) and risk distribution (from the insurer's perspective) in order to be characterized as insurance. Helvering v. LeGierse, 312 U.S. 531, 539 (1941); Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 411 (3rd Cir. 19XX).

Risk shifting occurs when a person facing the possibility of a loss transfers some or all of the financial consequences of the loss to the insurer. Rev. Rul. 88-72, 1988-2 C.B. 31, clarified by Rev. Rul. 89-61, 1989-1 C.B. 75. The risk transferred pursuant to an insurance contract must be a risk of economic loss. Allied Fidelity Corp. v. Commissioner, 66 T.C. 1068 (1976), aff'd., 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978).

Risk distribution refers to the operation of the statistical phenomenon known as the "the law of large numbers." When additional statistically independent risk exposure units are insured, although the potential total losses increase, there is also an increase in the predictability of average loss. This increase in the predictability of the average loss decreases the amount of the capital that an insurance company needs per risk unit to remain at a given solvency level. See Rev. Rul. 89-61, 1989-1 C.B. 75.

The Warranty Repair Insurance Policy

Based on the review of the activities conducted by ORG during the period of October 8, 19XX, through December 31, 20XX, it was determined that ORG wrote only a single insurance policy, annually. The annual policy provided warranty insurance to CO-2, which is owned by two of the three directors of ORG.

It appears that the primary and predominant activity of ORG is not insurance. The contracts executed between ORG and the CO-2 does not constitute insurance because the policy lacks the characteristic of risk distribution. In order for the contracts to be insurance, the characteristics of risk shifting and risk distribution must be present.

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With respect to the warranty repairs policy insured by ORG during years 19XX through 20XX, the IRS concedes that the policy holders shifted the risks associated with the policy ultimately to ORG. At issue, therefore, is whether ORG had adequate risk distribution on the policy.

One treatise on insurance in explaining risk distribution states that, “[w]hen insurance is considered from the viewpoint of an insurer ... it is appropriately viewed as a system for risk distribution as well as risk transference. Insurers deal with the uncertainty of whether a given insured will sustain a loss by combining the risks of loss for many ventures of a given type into a pool.” Keeton and Widiss, Insurance Law, A Guide to Fundamental Principles, Legal Doctrines, and Commercial Practices, p. 12, West Group (1988).

The Courts have not spent a great deal of time explaining what they mean by risk distribution. No court has squarely held that there can be no risk distribution if there is only one, or a few, insureds. A fair reading of the court opinions addressing the issue, however, supports the IRS’s position. See Barnes v. United States, 801 F.2d 984, 985 (7th Cir. 1986) (“Risk distributing is the spreading of the risk of loss among the participants in an insurance program.”). See also, Commissioner v. Treganowan, 183 F. 2d 288, 291 (2d Cir. 1950). Such spreading is effectuated by pooling among unrelated insureds. “...[R]isk distribution means that the party assuming the risk distributes his potential liability, in part, among others.” Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986). Risk distribution is accomplished where the risk is distributed among insureds other than the entity that incurred the loss. See Ross v. Odom, 401 F. 2d 464 (5th Cir. 1968).

The Sixth Circuit touched on the issue of risk distribution in Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989), noting there was adequate risk distribution, “where the captive insures several separate corporations within an affiliated group and losses can be spread among the several distinct corporate entities.” The Ninth Circuit has also measured risk distribution by explaining, “[i]nsuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums.” Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

There cannot be risk distribution when there is only one insured. During 19XX through 20XX, ORG failed to adequately distribute the risks associated with its warranty repair policy. During these years, the warranty repairs policy with CO-2 is the only policy insured by ORG. In addition, CO-2 is owned by officers/shareholders of ORG. ORG did not maintain “numerous” or “several” independent risks in exchange for “numerous” premiums, compared to the taxpayers in Humana and Clougherty. Insuring a single warranty repairs policy at any given time does not qualify as adequate risk distribution.

Conclusion

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We conclude that the warranty repair and replacement policy sold by ORG to CO-2, lacks the characteristic of "risk distribution," and therefore, is not insurance within the meaning of Helvering v. LeGierse, 312 U.S. 531, 539 (1941). Because the primary and predominant activity of ORG is not insurance, ORG does not qualify as an insurance company within the meaning of part I or part II of subchapter L, and does not qualify for tax-exempt status under I.R.C. § 501(c)(15) as a small insurance company.

B. Does ORG, a foreign company which made an election under I.R.C. § 953(d), continue to qualify for exemption from federal income tax as an organization described in I.R.C. § 501(c)(15)?

Facts:

ORG was incorporated in the Country on October 8, 19XX. CO-3 was the initial subscriber of ORG. Shares of ORG stock were subsequently transferred to its current shareholders, BM-1 (% interest), BM-2 (% interest) and BM-3 (% interest). ORG, a Country (CO-1) company, elected to be treated as a U.S. entity pursuant to I.R.C. section 953(d).

ORG filed an application on Form 1024 for recognition of exempt status under I.R.C. § 501(c)(15). The Form 1024 application, postmarked September 22, 20XX, was received by the Internal Revenue Service on September 25, 20XX. A Form 8718, User Fee for Exempt Organization Determination Letter Request, was also received by the Internal Revenue Service on September 25, 20XX. The application package included a CO-1 Memorandum of Association for ORG dated October 8, 19XX; and CO-1 Articles of Incorporation for ORG dated October 8, 19XX.

By letter dated October 12, 20XX, the Internal Revenue Service acknowledged receipt of the application and advised the applicant the Form 1024 application had been referred to the national office for ruling.

In its application for recognition of exempt status, ORG represented it operated, and would operate in the future, as follows:

ORG is organized and is currently functioning as an insurance company under the laws of the Country. ORG commenced insurance operations in 19XX to provide warranty insurance. ORG insures the customers of CO-2 for any warranty claims which may arise during the insolvency of CO-2 or during an assignment for the benefit of creditors of CO-2, or non-performance by CO-2, as a result of an "act of God." There are currently no plans to alter the future business activities from those as described above.

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Question 2 in Part II of the Form 1024 application requests financial information as follows: "List the organization's present and future sources of financial support, beginning with the largest source first." ORG's application made the following claims about financial support:

ORG's financial support is derived from the issuance of insurance contracts for a premium. Additional support is generated from investment income.

Part III of the application, Financial Data, reflects ORG's actual figures for 19XX. Proposed budgets for 20XX and 20XX were not included in the application. Part III of the application also shows revenue from insurance premiums in the amount of \$ for 19XX (covering the period October 8, 19XX, through December 31, 19XX). No projected figures for insurance premium revenues for 20XX and 20XX were reported. The same premium income information (\$) is provided at Schedule I. No other sources of revenue were reported in Part III of the Form 1024 application.

Under Part III, Assets, ORG lists "cash" on line 1 of \$ and "accounts receivable" on line 2 of \$. No other assets were reported in Part III of the Form 1040 application.

The application was signed September 7, 20XX, by BM-3, as director of ORG. Other directors listed on the application are BM-1 and BM-2. In a January 3, 20XX letter, prepared by CO-2, ORG disclosed that two directors, BM-1 and BM-2, are also co-owners of the CO-2

On September 7, 20XX, BM-3 signed a Form 2848, Power of Attorney authorizing CO-2 to represent ORG, in connection with the Form 1024 application, Forms 990 for 19XX through 20XX, and other returns (1120, 1120 PC, 1120L, 1120F) for the same period.

The Service, by letter dated October 25, 20XX, requested additional information from ORG. It asked for a description of the PROGRAM; a copy of all policies and/or service contracts executed by ORG; names and percentage of ownership of the CO-2; a copy of the annual report filed with CO-1 for 19XX; and proof of its IRC 953(d) election. In its January 3, 20XX response, ORG provided a two page narrative responding to IRS questions; a copy of the Warranty Repair/Replacement Insurance policy No: (four pages); and a two-page financial statement for Year 19XX. ORG disclosed that it does not reinsure any warranty insurance. ORG insures the customers of the CO-2 for any warranty claims which may arise during the insolvency of CO-2 BM-1 and BM-2, husband and wife, own % and % of CO-2, respectively. On the 19XX financial statement, ORG reported "premium income" of \$. No investment income was reported in the financial statement. Under "assets" the balance sheet showed "cash and accounts receivable" in the amount of \$. No liabilities or loss reserves were reported.

The Service issued a favorable determination letter to ORG on January 30, 20XX. The determination letter issued to ORG states:

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Based on the information supplied, and assuming your operations will be as stated in your application for recognition of exemption, we have determined you are exempt from United States income tax under section 501(a) of the Code as an organization described in [section 501(c)(15)] commencing on October 8, 19XX, for tax year(s) when your net written premiums (or, if greater, your direct written premiums) do not exceed the \$ limit as prescribed by this section 501(c)(15).

This ruling is based on the financial and other information submitted in support of your application. ***This ruling is not effective unless you actually operate as represented. *** Please notify the XYZ Employee Plans/Exempt Organizations (EP/EO) Customer Service office if there is any change in your name, address, sources of support, or method of operation.

ORG filed Forms 990 for the tax years 19XX through 20XX. The Internal Revenue Service examined ORG' Form 990 for 20XX and 20XX.

The Form 990 for 20XX was signed by the preparer at CO-2 on October 15, 20XX, and by BM-2 on November 15, 20XX. The 20XX Form 990 was postmarked on November 25, 20XX, and received by the Service Center on November 29, 20XX. The CO-2 preparer signed the Form 990 for 20XX on October 29, 20XX, and BM-1, President, signed the return on November 17, 20XX. The 20XX Form 990 was postmarked on November 17, 20XX, and received by the Service Center on November 21, 20XX. ORG is not tax-exempt for 20XX, and years subsequent, and filed Form 1120, U.S. Corporation Income Tax Return.

On examination, it was determined ORG had premium income of \$ in 20XX and \$ in 20XX; and investment income totaling \$ in 20XX and (\$) in 20XX. These figures, which were reflected on Forms 990 for 20XX, were confirmed by review of books and records.

Based on the examination of the activities and financial data for 20XX and 20XX, and the inspection of prior years' returns, the corporation's sole activity consisted of selling the initial warranty insurance policy to CO-2, and renewing such policy on an annual basis. The initial insurance policy, 19XX, was purchased by CO-2 on November 1, 19XX. The policy includes the following language:

The ORG ("Company") agrees to provide insurance protection as specified in this coverage for the NAMED INSURED(S) on whose behalf a premium has been paid. NAMED INSUREDS shall be construed to mean valid holders of Certificates of Insurance issued hereunder as a result of their purchase of products or services produced and sold by CO-2 ("CO-2").

Under the terms of the policy, ORG was responsible, specifically, to insure the customers of the CO-2 for any warranty claims that may arise during the insolvency of CO-2 or during an assignment for the benefit of creditors of CO-2 or non-performance by CO-2 as a result of an "Act of God".

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Since the inception of ORG, the CO-2 has been the sole holder of a Certificate of Insurance referred to in the terms of the policy. In addition, the CO-2 is the only insured and the only payer of insurance premiums to ORG. ORG has never sold warranty or any other type of insurance to any other party. No other policyholders existed during the period of October 8, 19XX to date. In the November 29, 20XX response to IDR #4, Attorney, provided the following information regarding the activities of ORG:

The only policy in effect during years 19XX through 20XX was policy number .⁵ This policy incorporates all three "lines of business" into a singular policy. ORG had intentions of writing additional policies in accordance with the three lines of business approved in the 19XX minutes; however, no other policies were written during that time period. It is the intent of ORG to expand its insurance coverage by writing wind/water/hurricane damage insurance. Currently, ORG has taken an inactive status with the Country Insurance Board until such time as final resolution of the current IRS audit.

From the date of inception through December 31, 20XX, ORG incurred no insurance claims because none of the acts initiating the coverage occurred. Nor were loss reserves set-aside by ORG to cover any anticipated future insurance claims.

The 20XX/20XX CO-2 Financial Statements, Note 2(e) included the following statement:

Policies written provide for coverage on a claims-made basis. Up to the date of the approval of these financial statements, no claims have been received. The Company has not made a reserve for policy losses and related expenses. However, because of the length of time required for the ultimate liability for losses and loss expenses to be determined, the net amounts that will ultimately be paid to settle any liability are not presently determinable.

The only other activity conducted by ORG, during the period of October 8, 19XX, through December 31, 20XX, was the selling and purchasing of securities and approving loans to the CO-2. ORG reported minimal operating expenses during this period. It incurred typical organizational costs such as licensing and fees, accounting fees, insurance administration fees, IRS application fee, and bank interest charges. ORG did not report the payment of salaries and wages because it hired no employees or other staff to conduct its business.

ORG provided no evidence of any other activities that it conducted during the period of October 8, 19XX, through December 31, 20XX.

* * * *

⁵ Policy executed with the CO-2 on November 1, 19XX.

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There was no evidence of any material changes in ORG' operations from those described in its Form 1024 application and the operations actually conducted by ORG.

Law:

Section 501(a) of the Internal Revenue Code provides that organizations described in I.R.C. § 501(c) shall be exempt from income taxation. Section 501(c)(15) describes as exempt "insurance 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 \$." I.R.C. § 501(c)(15). An organization is exempt under I.R.C. § 501(c)(15) only in those years in which it meets the \$ limitation on premium income. The premium income test includes amounts received by all entities in the exempt organization's controlled group. I.R.C. § 501(c)(15)(B), (C).

The exempt status of an organization may be recognized by the Internal Revenue Service through the application process described in a revenue procedure issued by the Service. See, e.g., Rev. Proc. 2004-1, 2004-1 I.R.B. 1; Rev. Proc. 90-27, 1990-1 C.B. 514. Although not required to apply for a determination letter in order to claim exempt status, organizations seeking recognition of exemption from the Internal Revenue Service under I.R.C. § 501(c)(15) must file a Form 1024, Application for Recognition of Exemption under Section 501(a).

A determination letter recognizing tax exempt status is issued by the Internal Revenue Service to an organization where its application and supporting documents establish that it meets the requirements of the category of exemption it claims. Rev. Proc. 90-27, § 5.01, 1990-1 C.B. 514. All information by the applicant must be provided under penalties of perjury. Rev. Proc. 2003-4, § 9.5 2003-1 I.R.B. 123, 140-141. The application process ends with the issuance of a determination letter. A "determination letter" is a written statement issued by the Internal Revenue Service in response to a written inquiry by an individual or an organization that applies to the particular facts. Treas. Reg. § 601.201(a)(3).

If the Commissioner revokes the tax-exempt status of an organization, the remaining question is whether the revocation should be applied prospectively or retroactively. Generally, revocation of a determination letter is prospective. Rev. Proc. 2003-4, § 14.01 (cross-referencing § 13.01 et seq.). Revocation of a determination letter may, however, be retroactive if the organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. Treas. Reg. § 601.201(n)(6)(i); Rev. Proc. 90-27, § 14.01; Rev. Proc. 2003-4, § 14.01 (cross-referencing § 13.01 et seq.).

Analysis

1. ORG Is Not Described in Section 501(c)(15) During the Years Under Exam.

To be exempt from federal income tax under I.R.C. § 501(a) as an entity described in I.R.C. § 501(c)(15), the entity must be an insurance company or association, other than life (including

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inter-insurers and reciprocal underwriters). In addition, it must meet a premium income requirement.

A producer-owned reinsurance company (PORC) like ORG is an “insurance company or association” for purposes of I.R.C. § 501(c)(15) if it issues insurance contracts, distributes and transfers insurance risks, and otherwise conducts business like an insurance company. As discussed at pages 2 through 14 of this report, ORG did not operate in accordance with the standards recognized by the Internal Revenue Service for an insurance company and, therefore, is not an insurance company for federal income tax purposes. Because the examination showed ORG is not an “insurance company,” it is not eligible to retain its exempt status under I.R.C. § 501(c)(15).

In addition, an entity described in I.R.C. § 501(c)(15) in a given year must not have net written premiums (or, if greater, direct written premiums) for that taxable year in excess of \$. I.R.C. § 501(c)(15). The premium income test applies to all entities in the exempt organization’s controlled group. I.R.C. § 501(c)(15)(B), (C). ORG is not a member of a controlled group within the meaning of IRC 831(b)(2)(B)(ii). ORG did not have net written or direct written premiums in excess of \$.

Because ORG was not an “insurance company or association” during the year under exam, it is not exempt from federal income tax under § 501(a) as an entity described in § 501(c)(15) and revocation of the Service’s recognition of exempt status is appropriate.

ORG Cannot Rely on Its Determination Letter

An organization may not rely on a favorable determination letter if the organization omitted or misstated a material fact in its application or in supporting documents. An organization also may not rely on a favorable determination if there is a material change, inconsistent with exemption, in the organization’s character, purposes, or methods of operation after the determination letter is issued. Treas. Reg. § 601.201(n)(3)(ii); Rev. Proc. 2005-4, I.R.B. 2005-1, 128, January 3, 2005.

The conclusion that ORG is not an “insurance company” during the years 20XX and 20XX rests primarily on an analysis of its sources of revenue and its business activities. See pages 10-26 of this report. In order to understand an organization’s financial structure and activities and conclude that the organization is an insurance company and, therefore, entitled to be recognized as exempt, it is critical for the Service to have complete financial information and also a fair and accurate description of the organization’s activities.

Primary source of financial support. The Form 1024 application at Part II, line 2, requires an applicant to identify its primary source of financial support. ORG listed insurance premiums first. ORG made the following representations: “ORG’s Financial Support is derived from the

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issuance of insurance contracts for a premium. Additional support is generated from investment income.”

On its Form 1024 application ORG represented that it was formed on October 8, 19XX. Financial information on the Form 1024 was presented for a short time frame from October 8, 19XX, through December 31, 19XX. ORG’ representation on the Form 1024 that it had actual revenue for 19XX of \$ from insurance activity for the short year period made sense in this context and bolstered the applicant’s representation that it was engaged in legitimate start-up insurance activities.

The Form 1024 application did not provide projected revenues for 20XX and 20XX. Nor were projected revenues for 20XX and 20XX requested in correspondence received from EO Technical. In the section of the application requiring ORG to include proposed budgets for 20XX and 20XX, ORG responded by entering “N/A”. ORG filed its initial Form 990 for 19XX, and reported income from insurance premiums of \$ as its only source of support.

Examination of ORG showed the source and amount of ORG’s “program service revenue” differed significantly from representations made in the Form 1024 application. The chart below shows the contrast between projected program service revenue for 20XX and 20XX, as reflected on the Form 1024 application, and actual revenue earned for 20XX and 20XX:

PROJECTIONS	FORM 1024 FIGURES FROM 990	ACTUAL REVENUE
20XX program service revenue	\$ -0-	\$
investment income	\$ -0-	\$ -0-
other revenue	\$ -0-	\$ -0-
Program service revenue	\$ -0-	\$
investment income	\$ -0-	\$
other revenue	\$ -0-	\$ -0-

The applicant’s description bears only a slight relationship to ORG’ actual operations from its inception in October 19XX, through December 31, 20XX. The method of operations described by ORG in its Form 1024 application differed from its actual operations, in that, ORG appears to insure CO-2, while its application indicates that it insures “the customers of CO-2” The examination revealed that ORG issued a single insurance policy in November 19XX, which was renewed annually for years 20XX, 20XX, and 20XX, for warranty repair and replacement

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insurance. The CO-2 is the only named insured in the policy. In addition, the CO-2 is the only payer of insurance premiums to ORG each year. Although the policy allows customers of the CO-2 to have products under warranty repaired or replaced, ORG does not collect insurance premiums directly from customers of the CO-2⁶

The information presented on the Form 1024 gave the clear impression that ORG would insure a "pool of risks" by executing numerous individual warranty repair and replacement policies with customers of the CO-2. While, in fact, ORG's actual business is that of insuring only the risk of the CO-2, which is co-owned by two of its shareholders, BM-1 and BM-2. ORG did not assume any insurance risks in addition to the warranty repair and replacement coverage. ORG did not once come back to the Internal Revenue Service to correct its description of activities or its income projections for 20XX or 20XX. Nor did ORG provide additional facts relating to those projections, as specified in ORG's determination application.

The following facts are critical to a determination of recognition of exemption under I.R.C. § 501(c)(15):

Source of income

(1) Primary source: ORG's primary source of revenue for 20XX and 20XX was insurance premium income. Premiums comprised % of total income for 20XX and % for 20XX. However, the Service determined that the premium income is not derived from insurance activities as defined in Helvering v. LeGierse, 312 U.S. 531, 539 (1941). ORG did not file Form 990 as a tax-exempt insurance company for 20XX.

Use of capital and efforts

No actual sales of insurance products. The only insurance product ever "sold" by ORG was the warranty repair and replacement policy sold to the CO-2. CO-2 is co-owned by two of ORG's shareholders. No other warranty repair or any other policies were sold by ORG to unrelated parties. The initial warranty repair policy with the CO-2 was renewed on an annual basis during years 20XX through 20XX.

Minimal effort. ORG devoted little time to its insurance activities, including the development and marketing of insurance products. Since its inception, ORG has not paid any claims under the warranty repair policy because none of the events that cause the policy to take effect have occurred (i.e. bankruptcy of the CO-2 Group, Inc).

* * * *

⁶ Nor is there any evidence that customers pay insurance premiums to the CO-2, which in turn, are reinsured by ORG. ORG is not engaged in reinsurance activities. ORG is a direct writer of the warranty repairs and replacement insurance that is sold to the CO-2

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As detailed above, ORG' Form 1024 application omitted relevant financial data. During the application process, ORG omitted source of income projections for 20XX and 20XX. In addition, ORG misrepresented that ORG would insure customers of the CO-2, when, according to the policy, the insured is, in fact, the CO-2. All of these facts, representations, and omissions were, in our view, material to the ruling on the application and go to the essence of the issues raised on examination.

We do not urge erroneous projections standing alone are the equivalent of misstatements of material facts. We grant in an uncertain world revenue projections can miss the mark.

With respect to a possible future request for relief under IRC § 7805(b), ORG may argue the projections at issue are not part of the retroactivity equation. Presumably, however, the IRS gives weight to financial projections during the application process. If so, the IRS presumably insists and requires the applicant disclose all known and relevant financial information that bear on those projections at the application stage to permit fair consideration of the financial picture of an applicant organization. As noted above, it is not the erroneous projections but omission of material facts relating to these projections that is significant.

These omissions of critical financial information affected the Service's consideration of the Form 1024 application. On its Form 1024, ORG also misrepresented its insurance activities.

Reinsurance activities: material misstatements.

In Part II of the Form 1024 application, ORG misrepresented that ORG would insure customers of the CO-2, when, according to the policy, the insured is, in fact, the CO-2. In its January 3, 20XX correspondence with the Internal Revenue Service, ORG provided a copy of the warranty repair and replacement policy, which includes the following language:

The ORG agrees to provide insurance protection as specified in this coverage for the NAMED INSURED(S) on whose behalf a premium has been paid.

This Policy is Issued in Trust to CO-2 for the benefit of customers of CO-2 to whom CO-2 has sold its various products or services; but, CO-2 shall have no fiduciary duty to any party other than as Custodian of the Policy.

For purposes of ORG' request for 7805(b) relief, this provides an additional ground to deny relief.

Materiality analysis. A fact (listed below) developed on examination that was not provided by ORG on its Form 1024 application:

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ORG failed to include income projections from its insurance activities and other sources for 20XX and 20XX.

In summary, we think the availability of this factual information would likely have prompted the Exempt Organizations Division to conclude ORG was not operated as an insurance company. Accordingly, in our view, ORG may not rely on its favorable determination letter.

3. Section 7805(b) Relief

While revocation of a determination letter is generally not retroactive, revocation of a determination letter may be retroactive if the organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. Treas. Reg. § 601.201(n)(6)(i). See also, Rev. Proc. 2004-1, 2004-1 I.R.B. 1; Rev. Proc. 90-27, §14.01 (cross-referencing § 13.01 et seq.), 1990-1 C.B. 514. In cases where the organization omitted or misstated a material fact, revocation may be retroactive to all open years under the statute. See Treas. Reg. § 601.201(l)(1). In cases where revocation is due to a material change, inconsistent with exempt status, in the character, the purpose, or the method of operation, revocation will ordinarily take effect as of the date of the material change. Treas. Reg. § 601.201(n)(6)(i); Rev. Proc. 90-27. In any event, revocation will ordinarily take effect no later than the time at which the organization received written notice that its exemption ruling or determination letter might be revoked. Treas. Reg. § 601.201(n)(6)(i).

In this case, the agent recommends that revocation should be revoked for the year that ORG' activities were not consistent with the requirements of IRC 501(c)(15). The Service determined that ORG did adequately disclose its operations in the Form 1024 application. However, during the examination of tax years 20XX and 20XX, the Service concluded that ORG did not operate primarily and predominantly for an insurance purpose because its agreement with CO-2 Group did not constitute insurance. Thus, ORG does not meet the requirements under I.R.C. § 501(c)(15), and revocation of its tax exempt status is proposed. Accordingly, it is recommended that ORG' tax exempt status be revoked, effective January 1, 20XX, the first day of the year under audit. In addition, the Service determined that ORG' election to be treated as a domestic corporation for tax purposes, under I.R.C. § 953(d) is not valid, and ORG should be treated as a "controlled foreign corporation" for tax years beginning January 1, 20XX.

Section 953(d) of the Code allows a foreign insurance company to elect to be treated as a domestic company for tax purposes if it meets certain requirements. One such requirement is that the foreign company must be a company that would qualify under part I or II of Subchapter L for the taxable year if it were a domestic corporation.⁷

* * * *

⁷ See section 953(d)(1)(B).

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If it is determined that a controlled foreign corporation ("CFC") does not qualify as an insurance company under part I or part II of subchapter L, it will fail to meet the requirements for electing under section 953(d)(1) to be treated as a domestic corporation. Therefore, it will be treated as a foreign corporation for tax purposes. As a foreign corporation with U.S. shareholders, it will potentially be subject to the subpart F, passive foreign investment company ("PFIC"), and foreign personal holding company ("FPHC") regimes.

Based on the facts reviewed, it is determined that ORG has not operated as an insurance company, within the meaning of Subchapter L of the Internal Revenue Code, since the date in which it was granted exempt status under I.R.C. § 501(c)(15). The primary and predominant activity of ORG is not the conduct of an insurance business.

Therefore, revocation of exempt status under I.R.C. § 501(c)(15) is proposed, effective January 1, 20XX, the first day of the tax year under audit.

IV. TAXPAYER'S POSITION:

A preliminary Revenue Agent's Report was mailed to Attorney, on December 2, 20XX. Attorney requested and received an extension of time to respond to the report until February 7, 20XX.

During a February 3, 20XX telephone conversation, Attorney's initial response was to agree that the contract between ORG and the CO-2 is not insurance because the contract lacks risk distribution. Attorney indicated that he will not contest the I.R.C. § 501(c)(15) exempt status of ORG. However, Attorney wanted to know if there would be any Subpart F consequences resulting from the proposed loss of ORG's tax-exempt status.

Attorney followed up the telephone conversation by submitting a fax on February 4, 20XX. In the fax, Attorney requested that the possibility for protesting the proposed revocation of exemption remain open. Attorney indicated that the organization disagreed that it is a Controlled Foreign Corporation ("CFC"), a Passive Foreign Investment Company ("PFIC") or a Foreign Personal Holding Company ("FPHC").

No other position was expressed by the Attorney or the organization in response to the preliminary Revenue Agent's Report.

V. CONCLUSIONS:

A. ORG is not an insurance company exempt from tax pursuant to I.R.C. § 501(c)(15) for the taxable years 20XX and 20XX, and thus, revocation of exempt status under I.R.C. § 501(c)(15) is proposed, effective January 1, 20XX.

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B. ORG, a foreign company which made an election under I.R.C. § 953(d), does not continue to qualify for exemption from federal income tax as an organization described in I.R.C. § 501(c)(15)?

C. Because ORG is not an insurance company, it made an invalid I.R.C. § 953(d) election to be taxed as a domestic corporation for the taxable years 20XX and 20XX. Instead, ORG is a controlled foreign corporation, and its shareholders are subject to tax on ORG's Subpart F income. Alternatively, the IRS could apply I.R.C. § 269 to disregard the tax benefits derived by the shareholders and CO-2 for the taxable years 20XX and 20XX derived from its formation of ORG.