IRS Manual and Release Excerpts:

IRM 4.76.23 on 501(c)(15) Companies

Internal Revenue Manual
Part 4. Examining Process
Chapter 76. Exempt Organizations Examination Guidelines
Section 23. Small Insurance Companies or Associations IRC 501(c)(15)

4.76.23 Small Insurance Companies or Associations IRC 501(c)(15)

4.76.23.1 (07-01-2005)
Introduction

1. This IRM section contains specific examination guidelines for an organization recognized as exempt from income tax under IRC 501(a) as an organization described in IRC 501(c)(15). It provides examination techniques effective in identifying and developing issues commonly encountered during the examination of an IRC 501(c)(15) organization.

2. These guidelines provide specific assistance for the examination of an IRC 501(c)(15) organization and are not all-inclusive. The purpose is to supplement the guidelines contained in IRM 4.75.10 through 4.75.12. The intent is not to restrict the examiner in identifying issues or using examination techniques not included herein.

3. This IRM does not contain detailed technical information regarding IRC 501(c)(15) organizations. The examiner should review the technical information contained in IRM 7.25.15.

4.76.23.2 (07-01-2005)
Background Information

1. IRC 501(c)(15) originally granted exempt status to entities referred to as 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 companies and other small companies and extended IRC 501(c)(15) to all eligible small companies, whether stock or mutual, other than life.

2. TRA-86 changed the nature of the ceiling amount for tax exemption from certain gross receipts to net written premiums (or, if greater, direct written premiums) which do not exceed $350,000 per year. This exemption also includes interinsurers and
reciprocal underwriters. These changes were made effective for tax years beginning after December 31, 1986.

4.76.23.3 (07-01-2005) Organizational Requirements

1. Effective for years beginning after December 31, 2003, Section 206 of H.R. 3108, Pension Funding Equity Act of 2004 (the Act), revised the definition of small property and casualty insurance companies (insurance companies other than life insurance companies) exempt from income taxes. Specifically, the Act amended IRC 501(c)(15) to provide that a property and casualty insurance company is eligible to be exempt from federal income tax if,

   A. Gross receipts for the taxable year do not exceed $600,000; and

   B. More than 50 percent of such gross receipts consist of premiums. See IRC 501(c)(15)(A)(i).

   Note: For purposes of these tests, amounts received by all members of the insurance company's controlled group (including foreign and tax-exempt companies) are taken into account. See IRC 501(c)(15)(C).

2. In the case of a mutual insurance company, the gross receipts of which for the taxable year:

   A. Do not exceed $150,000; and

   B. More than 35 percent of such gross receipts consist of premiums.

   Note: This clause shall not apply if any employee of the company, or a member of the employee's family (as defined in IRC 2032A(e)(2)), is an employee of another company exempt from taxation by reason of this paragraph (or would be so exempt but for this sentence).

4.76.23.4 (07-01-2005) Examination Guidelines

1. Review the operations of mutual insurance companies:

   A. Determine that the insurance company is not a life insurance company;

   B. Ascertain that the $600,000 gross receipts test (with more than 50 percent of total gross receipts consisting of premiums) is met; and

   C. Determine if the organization's activities are primarily the issuance of insurance.
2. If the organization is determined to be a life insurance company, has gross receipts in excess of $600,000, or if it has gross receipts not exceeding $600,000 but 50 percent or less of such gross receipts consists of premiums, it will no longer continue to qualify for recognition of exemption under IRC 501(c)(15).

4.76.23.4.1 (07-01-2005)
Life Insurance Companies

1. The examiner should review IRC 816, which provides a definition of a long-term life insurance company, and establishes a mechanical formula for determining whether an insurance company is a life insurance company. The definition of a life insurance company takes into account "life insurance reserves" and "unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves." A company is not a life insurance company unless these amounts exceed 50% of its total reserves.

4.76.23.4.2 (07-01-2005)
Gross Receipts Test

1. The examiner should ascertain that the gross receipts of the organization for the taxable year do not exceed $600,000 and more than 50 percent of such gross receipts consists of premiums.

2. The examiner should review IRM 7.25.15, which provides a definition of "net written premiums," "direct written premiums," and other pertinent terms.

3. All direct written premiums received by an insurance company during a tax year should be included in calculating the $600,000 gross receipts test, even though some of such income is not earned premium income for that tax year.

4.76.23.4.2.1 (07-01-2005)
Controlled Group

1. The Act retains the controlled group rule, now requiring aggregation of gross receipts with those of other members of its controlled group defined by IRC 831 and IRC 1563. See IRM 7.25.15.3.3.

2. The examiner must determine whether the insurance company is a member of a controlled group, as the gross income from all other members of the controlled group is included in the $600,000 gross income test.

4.76.23.4.3 (07-01-2005)
Transactions Between Related Parties

1. The examiner should review transactions between related parties to determine whether a significant tax avoidance effect exists, or if the transactions indicate a "sham."
The examiner should review IRC 845 regarding reinsurance agreements between related parties. Where there is evidence of tax avoidance or evasion, the examiner should determine whether there is a significant tax avoidance effect with respect to any reinsurance contract entered into by the insurance company that would require adjustments under IRC 845(b). Factors that the courts have looked at to determine whether the transaction was a sham have included:

A. Whether the parent formed the captive insurer with a legitimate business purpose;

B. Whether the captive insurer determined premiums at arm's length that reflect the insured's risk history and industry standards;

C. Whether there exist indemnification agreements or comfort letters that guarantee the performance of a captive insurer;

D. Whether the captive is thinly or over-capitalized;

E. Whether the captive’s reserves were actuarially determined at a fair and reasonable level and not inflated for tax avoidance reasons; and

F. Whether circular cash flows exist, such as loans from the captive insurer to its parent or other affiliated entity.

2. The examiner should review the governing instruments, and, as part of the initial contact or interview:

A. Obtain the names and family relationships of the shareholders in the controlled group;

B. Determine whether the insurance company insures parties related to its shareholders; and

C. Determine whether the insurance company reinsures insurance products produced by entities financially related to its shareholders.

Caution: Rev. Rul. 77-316 has been revoked by the issuance of Rev. Rul. 2001-31, 2001-26 I.R.B. 1348, June 25, 2001. Therefore, an identity of ownership interests between the shareholders of the "producer taxable entities" (i.e., the source of the insurance business) and the insurance company shareholders (or identical shareholders, for that matter) will no longer be sufficient without additional facts to justify revocation of exemption on the basis that the "producer taxable entity" and insurance company are within the same "economic family," that is, have identical owners. With the revocation of Rev. Rul. 77-316, the "economic family" rationale can no longer be used for revocation of exemption. Instead, it is necessary to apply directly the facts and standards in the LeGierse and Malone & Hyde cases (see below). Agents seeking revocation on this basis are advised in all instances to seek technical advice from the
4.76.23.4.4 (07-01-2005)
Insurance Contracts

1. Exemption under IRC 501(c)(15) provides that an organization's primary and predominant activity must be that of an insurance company engaged in the business of issuing and servicing insurance contracts. An insurance contract must shift and distribute a risk of loss, and that risk must be an "insurance" risk, as stated in Helvering v. LeGierse, 312 U.S. 531(1941). Also, see Rev. Rul. 89-96, which holds that the assumption of investment risk cannot create an insurance agreement. The examiner should conduct a sample review of the contracts issued by the organization to determine if they qualify as insurance contracts.

4.76.23.4.5 (07-01-2005)
Captive Foreign Corporation

1. The examiner should ascertain whether the insurance company is a captive foreign corporation and whether it has made an election under IRC 953(c)(3)(C) or IRC 953(d). If so, obtain a complete copy of that election and determine if it satisfies the annual information requirements of Rev. Proc. 2003-47, 03-28 I.R.B. 55.

Note: Rev. Proc. 2003-47 details the required contents of the election. Those contents include not only a calculation under the "US Assets Test," but also a list of U.S. shareholders that includes their SSN's, percentage of ownership interests and addresses. Further, Rev. Proc. 2003-47 requires that the election be UPDATED yearly if there is a change in ownership interests or owners. A copy of the update must be filed with the Form 990 in the year of change. IRC 1563(b)(2)(c) excludes foreign corporations subject to tax under IRC 881 from the definition of a controlled group and, therefore, would deny exemption under IRC 501(c)(15). If the foreign corporation has made an election under either IRC 953(c)(3)(C) or IRC 953(d), then it will not be treated as an excluded member under IRC 1563(b)(2)(c).

2. If the insurance company is a captive foreign corporation, determine whether it is operated like the organization described in Malone & Hyde Inc. v. Commissioner, 62 F.3d 835 (6th Cir. 1995). The Sixth Circuit concluded since there was no shifting and distribution of the risk of loss to unrelated parties, there was no insurance, and the offshore insurance subsidiary was a sham corporation propped up by its parent.

Note: Per Rev. Rul. 2001-31, the Service may, however, continue to challenge certain captive insurance transactions based on the facts and circumstances of each case. See, e.g., Malone & Hyde Inc., which concluded that brother-sister transactions were not insurance, because the taxpayer guaranteed the captive's performance, the captive was thinly capitalized and loosely regulated; and Clougherty Packing Co. v. Commissioner, 811 F.2d 1297 (9th Cir. 1987), which concluded that a transaction between parent and subsidiary was not insurance.
4.76.23.5 (07-01-2005)
Insurance Companies in Liquidation

1. Insurance companies in liquidation that no longer receive premiums and their main source of income is investment income may qualify for exemption under IRC 501(c)(15) if they meet the transitional rule for companies in receivership or liquidation.

2. For insurance companies in liquidation, the examiner should:

A. Review the court documents to determine the date on which the insurance company could no longer write insurance;

B. Determine whether the insurance company received gross receipts in excess of $600,000 before the date on which it could no longer write insurance. If so, the insurance company does not qualify under IRC 501(c)(15) for such tax year;

C. Determine whether the insurance company has outstanding policies on which it is liable. If not, the insurance company does not qualify under IRC 501(c)(15);

D. Determine whether the insurance company's assets exceed the needs of the business. If so, the examiner would then determine if the company is primarily in the insurance business; and

E. Determine whether the insurance company has received reinsurance or premiums during a tax year. If so, the insurance company would not qualify under IRC 501(c)(15) if 50 percent or less of its gross receipts consisted of premiums.

4.76.23.5.1 (07-01-2005)
Transitional Rule for Companies in Receivership or Liquidation

1. The Act provides a transition rule for insurance companies in receivership or liquidation. In the case of a company or association that, for the taxable year that includes April 1, 2004, meets the requirements of IRC 501(c)(15)(a), as in effect for the last taxable year beginning before January 1, 2004, and that is in a receivership, liquidation, or similar proceeding under the supervision of a State court on April 1, 2004, the amendments made by the Act apply to taxable years beginning after the earlier of the date such proceeding ends or December 31, 2007.