Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Contact Person:
XXXXXXXXXXXXXXXXX

Telephone Number:
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In Reference to:
XXXXXXXXXXXXX

Date:
JAN 13 1999

Legend:

Y= XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
N= XXXXXXXX
M= XXXXXXXXX
W= XXXXXXXXXXXXXXXXXXXXXXXXX
Z= XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
T= XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

Dear Applicant:

This refers to your letter of September 2, 1997, as supplemented by subsequent correspondence dated August 3, 1998, in which you requested us to respond to the following questions with respect to certain proposed changes with respect to your operations:

1. "Can our tax exempt status be amended to cover Y's operations? If such is a possibility, we need your office to advise us regarding what you need.

2. If the response to Question 1 is NO, and (since) we are the sole shareholder of Y, what impact would Y's earnings have on us? Would Y's earnings be reported on our Form 990, and, if so would there be unrelated business income or unrelated business loss ..."

3. If the above response is negative, how should the Y's shares be held and what type of corporate entity should it be, an S or C corporation?

You were recognized as exempt from federal income tax as an organization described in section 501(c)(15) of the Internal Revenue Code by exemption letter dated August 30, 1990. Your exemption letter shows that you operate on a fiscal year basis ended April 30.

The information furnished shows that you are not incorporated, but are an unincorporated association. The information furnished reflects that you have been in existence for over 60 years. The information furnished shows that you

collect fire and other casualty insurance premiums from members of M churches located in the State of N.

You state that you remit all premiums (except for the premiums on the first $12,000 of coverage which you self-insure) to W who is your agent. You state that W reinsures the balance of the coverage written with Z.

The information furnished shows that Z operates a retrocession pool for all M insurance plans located in the United States. You state that after deductions for commissions and retrocession pool losses, Z remits a portion of the premiums to you and other M insurance plans in the United States.

You operate on a fiscal year basis ended April 30. However, section 843 of the Code provides that the annual accounting period for each insurance company. subject to tax, shall be the calendar year.

You state that your insureds have difficulty in obtaining auto and other liability insurance and for this reason you formed Y as an insurance agency to handle auto and liability coverage for your insureds. You are Y's sole shareholder.

You represent that Y will handle all auto and general liability coverage. You represent that Y will not take a commission on the policies it sells to your insureds, instead Y will assess a policy fee to cover its administrative costs and operating expenses. Further you represent that Y will operate on a breakeven basis.

You indicate that the same individuals that you use to write your coverage will accept applications and handle policies for Y. Further, you represent that your office's administrative and secretarial personnel will be employees of Y. In addition, you represent that these individuals, who will sell and service policies issued by T, will be compensated as sub-agents on a commission basis.

You state that insurance coverage will be written by Y with T, and that all risks will lie with T rather Y. Further, you state that under this type of arrangement, Y has no capital or reserve requirements and that Y takes no "risks".

Section 501(c)(15) of the Code, as amended, provides for the exemption of:

> (A) 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 $350,000.

This subsection also provides as follows:

(B) For purposes of subparagraph (A), in determining whether any company or association is described in subparagraph (A), such company or association shall be treated as receiving during the taxable year amounts described in subparagraph (A) which are received during such year by all other companies or associations which are members of the same controlled group as the insurance company or association for which the determination is being made.

(C) For purposes of subparagraph (B), the term controlled group has the meaning given such term by section 831(b)(2)(B)(ii).

Section 831(b)(2)(B)(ii) of the Code provides that:

"[f]or purposes of clause (i) the term 'controlled group' means any controlled group of corporations (as defined in section 1563(a)); except that -

(I) 'more than 50 percent shall be substituted for 'at least 80 percent' each place it appears in section 1563(a), and

(II) subsections (a)(4) and (b)(2)((D) shall not apply."

Section 512(b)(13)(A) of the Code provides in effect that if an organization (the controlling organization) receives directly, or indirectly, payments from another entity which it controls (the controlled entity) the controlling organization will include such payment as an item of gross income (regardless of the application of 512(c)(1), (c)(2) and (c)(3) of the Code) if such payment reduces the controlled entity's net unrelated income.

Section 843 of the Code provides that the annual accounting period for each insurance company, subject to tax, shall be the calendar year.

Section 1361(a)(1) of the Code, in pertinent part, defines an S Corporation as a "small business corporation."

Section 1361(b)(1) of the Code provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation.

Section 1361(b)(2)(B) of the Code provides, in pertinent part, that an ineligible corporation is an insurance company subject to tax under sub-chapter L.

Section 1361(c)(6) of the Code provides, in pertinent part, that for purposes of section 1361(b)(1)(B) an organization described in section 501(c)(3) and exempt under section 501(a) may be a shareholder in an S corporation.

Section 1504(b)(1) of the Code states that "corporations exempt from taxation under section 501 are not "includible corporations" within the meaning of section 1504(a)(1) of the Code. Further, section 1504(b)(2) of the Code states that "insurance companies subject to taxation under section 801" are not "includible corporations" within the meaning of section 1504(a)(1) of the Code.

The term "insurance company" has the same meaning under section 501(c)(15) as under Subchapter L of the Code (relating to taxation of insurance companies). See II Conf. Rep. No. 99-841, 99th Cong. 2d Sess. 370-71, reprinted in 1986-3 (Vol.4) C.B. 370-71; see also Rev. Rul. 74-196, 1974-1 C.B. 140, for a similar conclusion under prior law.

Section 1.801-3(a)(1) of the Income Tax Regulations defines the term "insurance company" to mean 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. See also Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932).

Rev. Rul. 68-27, 1968-1 C.B. 315, provides, in part, that the meaning of the term "insurance company" as defined in section 1.801-3(a) of the regulations is equally applicable to insurance companies other than life. See sections 1.831-1(a) and 1.831-3(a) of the regulations. Thus, the primary and predominant business activity of an organization qualifying as an insurance company must be the issuing of insurance contracts. In Rev. Rul. 68-27, since the predominant business activity of the organization was not the issuance of insurance contracts, the organization did not qualify as an insurance company.

The principal test for what constitutes "insurance" is set out in Helvering v. LeGierse, 312 U.S. 531 (1941). In that case the Supreme Court states that "[h]istorically and commonly

insurance involves risk-shifting and risk-distribution...." Further, the Court stated that "the risk must be an 'insurance risk' as opposed to an 'investment risk'...." The court in Epmeier v. United States, 199 F.2d 508, 509-10 (7th Cir. 1952), defined an insurance contract as a "contract, whereby, for an adequate consideration, one party undertakes to indemnify another against loss from certain specified contingencies or perils...."

Because Y is an insurance agency and is not an insurance company as described in section 1.801-3(a)(1) of the regulations, Y would not qualify for recognition of exemption under section 501(c)(15) of the Code. Further, pursuant to section 1504(b)(2) of the Code, "insurance companies" subject to taxation under section 801 are not "includible corporations" within the meaning of section 1504(a)(1) of the Code. Thus, you cannot file a consolidated return with Y.

Further, if Y were an insurance company it would have to establish its own right to recognition of exemption under section 501(c)(15) of the Code by filing Form 1024.

Because you are an insurance company, pursuant to section 843 of the Code, you must file your return on an annual basis.

You asked whether Y should file as a C or S corporation. Since you are the sole shareholder of Y and since you are not an exempt organization as described in section 1361(c)(6) of the Code, Y is not eligible to be an S Corp.

The Taxpayer Relief Act of 1997 modified the test for determining "control" for purposes of IRC 512(b)(13). Control now means ownership by vote or value of more than 50% of a company's stock, or in the case of a partnership or other entity, ownership of more than 50 percent of the profits, capital or beneficial interests.

The Taxpayer Relief Act of 1997 now applies the constructive ownership rules of section 318 of the Code for purposes of section 512(b)(13) of the Code. Thus, an exempt parent organization is deemed to control any subsidiary in which it directly holds more than 50 percent of the voting power or value.

Congress also made technical modifications to the method provided for determining how much of interest, rent, annuity, or royalty payment made by a controlled entity to an exempt organization is includible in the latter organization's unrelated business taxable income. Such payments are subject to the unrelated business income tax to the extent the payment reduces the net unrelated business income (or increases any net unrelated loss) of the controlled entity.

A section 501(c)(15) insurance company may receive income from any source permitted to any for-profit insurance company. It appears that any section 501(c)(15) insurance company may receive income from any insurance related source and may invest in and receive income from most investment ventures.

Thus, even though a section 501(c)(15) insurance company is subject to the unrelated business income tax provisions of sections 511 through section 514 of the Code, under the circumstances described above, the income Y receives from T is not unrelated business taxable to it. Thus, the income you receive from Y is not unrelated business taxable income to you. Therefore, we conclude that you would not be subject to the unrelated business income tax on income that you receive from Y pursuant to the provisions of section 512(b)(13) of the Code.

Based on the above we rule as follows:

1. Your tax exempt status cannot be amended to cover Y's operations.

2. Y's earnings would have no impact on you. Y would have to file a corporate return Form 1120.

3. Y's earnings cannot be reported on your Form 990.

4. Even if Y were an exempt organization under section 501(c)(15) of the Code, Y would have no unrelated business taxable income. Thus, any income received by you from Y would not be unrelated business taxable income under section 511 of the Code pursuant to the provisions of section 512(b)(13) of the Code.

5. Because you are not a section 501(c)(3) exempt organization, Y may not elect to be an S corporation.

This ruling letter is directed only to the organization that requested it. Section 6110 of the Code provides that it may not be used or cited as precedent. We are sending a copy of this ruling letter to your key District Director and to your attorney.

Sincerely yours,

Kenneth J. Earnest

Kenneth J. Earnest
Acting Chief,
Exempt Organizations
Technical Branch 3