Internal Revenue Service

Number: **200332014**
Release Date: 8/8/2003
Index Number(s): 0831.00-00; 0831.02-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:4/PLR-100302-03
Date:
May 1, 2003

Legend

Taxpayer =

Target =

State A =

Year 1 =

Year 2 =

Year 3 =

Year 13 =

Year 15 =

Year 16 =

Year 17 =

Dear :

This responds to your request for our consent to Taxpayer's revocation of its election under § 831(b) to be taxed only on its investment income effective for Year 17.

Taxpayer is a calender year mutual property insurance association operating continuously in State A since Year 1 and incorporated in that state since Year 2. The risks Taxpayer assumes are generally limited to coverage against the loss of, or damage to, property. Taxpayer elected to be taxable only on its investment income under § 831(b) for the tax years beginning on January 1 of Year 3.

Target, prior to the January 1 of Year 16, was a mutual property insurance company organized under State A law. Target generally limited the risks it assumed to coverage against losses to property. From January 1 of Year 3 through the end of Year 15, Target, for federal income tax purposes, was a non-life insurance company exempt from taxation under § 501(c)(15) because its net written premiums (or, if greater, direct written premiums) for these taxable years did not exceed $350,000. On January 1 of Year 16, Target merged into Taxpayer under the laws of State A.

Section 831 provides generally that insurance companies, other than life insurance companies, are taxed on their taxable income. Section 831(b) allows certain small non-life insurance companies to elect to be taxed on their taxable investment income only. This election is found under § 831(b)(2)(A)(ii), and a company is eligible to make the election if, as provided in § 831(b)(2)(A)(i), its net written premiums (or if, greater, direct written premiums) for the taxable year exceed $350,000, but do not exceed $1,200,000. Once the election is made, the company's "taxable investment income" is computed under § 834.

At the time Taxpayer made the § 831(b) election in Year 3 the make-up of the types of policies that Taxpayer was writing was predominately farm policies. With the reduction of the number of farms in State A, Taxpayer's current writings are growing towards homeowner and light commercial agricultural policies. A light commercial agricultural policy involves such situations as a farmer operating a farm implement repair shop on his farm in order to increase his revenue. Such coverage presents additional risk as compared to a traditional property policy.[1]

The risk limits of the policies written have increased over the years since Taxpayer filed its election. Specifically, Taxpayer's average risk quadrupled since Year 3.

At the time Taxpayer made the § 831(b) election for Year 3 it was only allowed to write insurance in 6 counties within State A. In contrast, in Year 13, Taxpayer amended its charter such that it could insure property in any county in State A provided it received permission from the State A insurance Commissioner. Currently, Taxpayer can insure property in 21 counties in State A.

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[1] Insuring a farm implement repair shop requires not only insurance for the farm buildings but also for any farm equipment that may be damaged while being repaired. For example, a normal farm policy would not cover a combine that was damaged by a fire while the combine was in the custody and care of the insured for repairs. In fact, a normal farm policy would specifically exclude such coverage.

At the beginning of Year 16, Target merged with Taxpayer nearly doubling the number of policyholders of the combined entity. Measured by year-end Year 16 figures compared with year-end Year 15 figures, the merger resulted in an increase of 167% in gross premiums, (2) a 170% increase in gross assets, and (3) a 162% increase in taxable investment income.

As a result of the merger, Taxpayer had to adopt the broadest policy provisions that were previously issued by either Target or Taxpayer. More “perils of coverage” are now included as standard coverage under the new Taxpayer policies, particularly in the area of farm personal property coverage. The discounts on the new homes (homes less than 30 years of age), preferred property discounts, and higher deductible credits that were offered by one company but not the other must now be applied to the new Taxpayer policies. The rate structures of both Target and Taxpayer were combined allowing the lowest rate for similar risks to be changed so that policyholders did not suffer higher premiums as a result of the merger. Further, under Taxpayer’s present and future reinsurance contracts, it will have to purchase more facilitative reinsurance due to the size of risks that are encounter on today’s farmsteads.

Taxpayer submitted data for the five taxable years prior to Year 17 comparing its actual tax results as an electing company under § 831(b) with the tax results that Taxpayer would have had if it had not made the election. Further, Taxpayer represents that it will not make an election under § 831(b) to be taxed on only its investment income for any of the first five taxable years following the year (Year 17) to which the consent relates.

Section 1010(f) of the Technical and Miscellaneous Revenue Act of 1988 added the flush paragraph following § 831(b)((2)(A)(ii), which states: “The election under clause (ii) shall apply to the taxable year for which made and for all subsequent years for which the requirements of clause (I) are met. Such election once made may be revoked only with the consent of the Secretary.”

In making the change, Congress indicated that in adopting the amendment it intended that the election not be used as a means of eliminating tax liability (e.g., by making the election only for years when the taxpayer did not have net operating losses). Rather, it is intended that the election be a simplification measure for small companies. H.R. Rep. No. 795, 100th Cong., 2d sess.121 (1988); S. Rep. No. 445, 100th Cong., 2d Sess. 127 (1988).

As indicated above, Taxpayer has shown that since the time it made the election to be taxed only on its investment income in Year 3 the nature of its business has changed substantially.

In view of the foregoing, Taxpayer requests that consent be granted to the revocation to its § 831 election.

Provided that Taxpayer has not postponed the securing of reinsurance (on its risks) or any other underwriting expense item in anticipation of securing our consent to its revocation, consent is hereby granted to the revocation of Taxpayer's § 831(b) election effective for Year 17.

No opinion is expressed under other sections of the Code and income tax regulations that may also be applicable. This ruling is directed only to the taxpayer who requested it.

Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax returns to be filed by Taxpayer with respect to the taxable year with respect to which the consent is granted, and the next succeeding five taxable years.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

DONALD J. DREES, JR
Senior Technician Reviewer
Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: