INTERNAL REVENUE SERVICE

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Legend

Taxpayer =

State A =

YEAR 1 =

YEAR 7 =

YEAR 8 =

Date A =

Target =

This is in response to letters of October 18, 2000, December 19, 2000, January 4, 2001 and February 7, 2001 requesting consent to Taxpayer's revocation of its election under § 831(b) to be taxed only on its investment income effective for the calendar 2000 tax year.

Taxpayer is a small mutual insurance company incorporated in State A and is taxable under § 831. Taxpayer has been in the insurance business for many years and presently provides only property insurance for homes, farms and farm buildings.

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 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 it 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.

Taxpayer made the § 831(b) election for YEAR 1 with the filing of its U.S. Property and Casualty Insurance Company Income Tax Return. At that time Taxpayer was a county mutual insurance association that was only allowed to write insurance in the county where it was located and any county adjacent to the county where it was located. Further, at the time when it made the election, Taxpayer's major way of mitigating its losses was by purchasing reinsurance. Thus, reinsurance was paramount in allowing Taxpayer to protect its assets from losses.

On Date A of YEAR 7, Taxpayer acquired all the assets of Target, another State A county mutual insurance association, in a statutory merger. Subsequently, Taxpayer, as the surviving company in the merger, restated its articles of incorporation and bylaws so that it would operate under an more expansive charter that would allow it to increase the geographic area in which it was allowed to write insurance so that it included all of State A. Also after the merger Taxpayer adopted a different business strategy with regard to reinsurance. Instead of being as reliant as it was upon reinsurance to protect its assets, Taxpayer endeavored to retain more of the risks it assumed from its customers, but more diligently manage those risks.[1] For example, Taxpayer became more active in assessing its customers and their risks and more selective in assuming risks (even to the extent of refusing to assume certain customer risks). Also as part of this strategy, Taxpayer became involved in loss prevention by working with its customers to better manage their risks. Another post-merger changed circumstance was the narrowing of Taxpayer's margins between the amount of premiums that it could charge and the cost of losses to farm buildings (and other property) when those losses occurred. Taxpayer's customers, grain and livestock farmers, had been since YEAR 8 in a depressed economic environment with grain and livestock prices at all time lows, while cost of operations, such as gasoline and fertilizer prices, have continued to increase. During this same period there has been a strong overall (United States) general economy, which has put commercial and residential construction at their highest levels in years. This, in turn, has increased the cost of building and replacement materials for the losses that Taxpayer has sustained in recent years. In several years, Taxpayer's tax liability was larger than those liabilities would have been had its § 831(b) election not been in effect. Finally, it should be noted that Taxpayer's premium volume has tripled since the YEAR 7 merger.

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 an election once made, may be revoked only with the consent of the Secretary."

In making that 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 a net operating losses). Rather, it 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 its merger with Target in YEAR 7, the character of its business has changed significantly in its: (1) available geographic area, (2) reinsurance strategy, and (3) historic profitability margin between the amounts it can charge for

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[1] In spite of the changed business strategy of being less reliant upon reinsurance, external forces, viz., legislative enactments in Year 8 caused Taxpayer to be exposed to higher reinsurance premiums.

premiums and the cost of replacing and repairing damaged property. Further, since the merger the amount of premiums written by Taxpayer has tripled.[2]

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

Taxpayer understands that § 831(b) prohibits a net operating loss from being carried over from years in which a § 831(b) election was in effect to the year (or subsequent years) for which the revocation was effective.

Provided that Taxpayer will not make an election under § 831(b) to be taxed only on its investment income for the first five taxpayer years following the years to which this consent relates, consent is granted to the revocation of that election to be effective for the year 2000.

No opinion is expressed under other sections of the Code and income tax regulations that may also be applicable. The 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 cites 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 this consent is granted, and the next succeeding five taxable years.

Sincerely yours,
Acting Associate Chief Counsel
(Financial Institutions & Products)
By:Donald J. Drees, Jr.
Senior Technician Reviewer
Branch 4

[2] If the present rate of increase of annual premiums continues, within the next few years, Taxpayer's premium volume will exceed the $1,200,000 limit in section 831(b)(2)(A)(i) and it will no longer be subject to the section 381(b) election for the year it exceeds $1,200,000.