148488

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-252146

February 8, 1993

148488

Mr. Michael P. Dolan
Acting Commissioner
Internal Revenue Service

Dear Mr. Dolan:

During the summer of 1992 we initiated a review of tax-exempt insurance companies. We became aware that certain companies covered by Section 501 (c) 15 of the Internal Revenue Code could be escaping taxation for significant amounts of investment income. This section allows tax exemptions for small property and casualty insurance companies. There is potential for companies with small amounts of premium income and large amounts of investment income to obtain tax exempt status and not pay taxes on their investment income. Congress originally intended to provide tax relief to small, local insurance companies that provide insurance to rural and farm communities. We wanted to determine if the intent of this provision is still being met.

Prior to tax year 1986 a property or casualty company could qualify for tax exempt status if it was a mutual company and had gross receipts less than $150,000. The Tax Reform Act of 1986 expanded this provision, providing tax exempt status to both mutual and stock companies which have no more than $350,000 in net or direct written premium income. This change made it possible for a company with sizable investment income to be tax exempt if it has a small premium base.

We requested the Return of Organization Exempt From Income Tax (IRS Form 990) forms for 298 insurance companies which were ruled tax exempt under 501 (c) (15) since 1986. We received and examined 196 returns for 1989, 199 for 1990 and 190 for 1991. We also met with members of your staff, representatives of an insurance organization and a state insurance agency.

We found, for the most part, that the insurance companies qualifying for the tax exemption since 1986 are generally small companies that seem to be the types of organizations Congress intended to assist under section

056421/148488

501 (c) 15. For tax years 1989, 1990 and 1991, the companies had an average net income of $257,031, average assets of $2,861,573 and average liabilities of $2,994,341. The small size of these companies is even more clear when the larger companies that are anomalies are dropped from the calculations (4 in 1989, 5 in 1990 and 6 in 1991). The average net income becomes $59,666, the average assets are $1,319,999 and the average liabilities are $755,193.

In a few isolated instances, companies have earned large amounts of investment income tax free under the revised section 501 (c) (15). Of the returns reviewed, 7 companies earned over $1 million in investment income (the largest being $8.4 million). Some of these companies have large liabilities and currently do not sell insurance. Investment income is derived from assets accumulated when the companies were selling insurance. Because we found few companies with substantial investment income, little revenue appears to have been foregone.

In doing our work, we transferred appropriate data from the IRS Forms 990 to a database for analysis. As IRS makes progress in the automation of Form 990 data under its Tax Systems Modernization effort, you should be able to perform similar analyses. However, the reliability of such analyses depends on sound data. In our prior report entitled Tax Administration: Availability and Completeness of Returns for Tax-Exempt Organizations GAO/GGD 88-128, September 1988, we reported that many Forms 990 were incomplete and missing supporting schedules. We wanted to let you know that during the course of this review we found that the service centers were unable to locate all the Forms 990 requested.

We have completed our study and have briefed the Joint Committee on Taxation on our results. If you or your staff have any questions regarding this assignment, please feel free to contact me or Mike Brostek at (202) 272-7904.

Sincerely,

Hazel E. Edwards

for

Natwar M. Gandhi
Associate Director
Tax Policy and Administration Issues
(Job Code 268569)