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MEMORANDUM

Re: Notice 2006-42 — Guidance on “Gross Receipts” under I.R.C. § 501(c)(15)

From: Susan J. Hotine

Date: April 21, 2006

This afternoon, the IRS released Notice 2006-42, which provides guidance as to the meaning of “gross receipts” for purposes of I.R.C. § 501(c)(15). The concept of “gross receipts” as a qualifying measure for exemption from federal income tax under I.R.C. § 501(c)(15) was added by the Pension Funding Equity Act of 2004, but was not defined. This Notice favorably addresses an issue that was first raised with Treasury and IRS representatives at a semi-annual meeting of the tax committee of the NAMIC — that the “gross receipts” concept used to determine whether a tax-exempt entity is required to file a Form 990 would be distortive and inappropriate if used for purposes of determining whether a small insurance company is eligible for exemption from federal income tax under I.R.C. § 501(c)(15).

Notice 2006-42 states that, for purposes of I.R.C. § 501(c)(15)(A), gross receipts includes amounts received from the following sources: (1) premiums (including deposits and assessments), without reduction for return premiums or premiums paid for reinsurance; (2) the gross investment income of a non-life insurance company (as described in I.R.C. § 834(b)); and (3) other items that are properly included in the taxpayer’s gross income under the provision for computing taxable income. Thus, gross receipts include tax-exempt interest and the gain (but not the entire amount realized) from the sale or exchange of capital assets, both of which are included in gross investment income. Other than premium income or gross investment income, gross receipts does not include any amount that are not otherwise included in gross income. Thus, it does not include contributions to capital, or salvage or reinsurance recovered (which are accounted for as offsets to losses incurred).

Items (1) and (2) of the explanation for “gross receipts” are essentially identical to the “gross amount received” standard of pre-1986 law. Item (3) is additional, but specifically is limited to items that are gross income under subchapter B of chapter 1 of the federal income tax provisions (I.R.C. §§ 61-140).