INTERNAL REVENUE SERVICE

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Taxpayer =

Parent =

Subsidiary =

Commercial IC =

State =

Date A =

Year 1 =

Year 4 =

Year 9 =

x =

This responds to the letter dated September 20, 2000 submitted on behalf of Taxpayer by its representative. Taxpayer requests a letter ruling to support its request for change in accounting method for 2000 to the method required under § 832 for insurance companies subject to tax under § 831. The principal rulings requested are that: (1) Certain mechanical protection contracts issued by Taxpayer are insurance contracts for federal income tax purposes; (2) Taxpayer is an insurance company for federal income tax purposes; and (3) Taxpayer will be entitled to deduct (as reinsurance premiums) amounts paid to an unrelated insurance company in connection with the transactions described below.

FACTS

Taxpayer was incorporated in State on Date A and is principally engaged in the provision of motor vehicle protection plans. Taxpayer is not recognized as an insurance company under the laws of State. All of the stock of Taxpayer is owned by Parent, which is a holding company also incorporated under the laws of State. In turn, Taxpayer owns all of the stock of Subsidiary, which is incorporated under the laws of State and provides computer related support. Taxpayer and Subsidiary are includible members in Parent's consolidated income tax return.

Automobile dealers unrelated to Taxpayer offer the purchasers of new and used vehicles the opportunity to purchase vehicle protection contracts under Taxpayer's program. The vehicle protection contracts are designed to provide the purchaser with coverage in the event of a mechanical breakdown not otherwise covered by the manufacturer or automobile dealer. Numerous plans are available to vehicle purchasers based upon the type of coverage desired, the length of coverage desired, and the year and mileage of the vehicle to be covered.

The vehicle protection plans in Taxpayer's program include both a "dealer obligor" plan and an "administrator or Taxpayer obligor" plan. The type of plan offered is determined based upon whether or not state law allows an automobile dealer to sell a Taxpayer (administrator) obligor plan. The primary difference between these two plans is the identity of the party the purchaser enters into the agreement with. Under a dealer obligor plan, the dealer is a party to the agreement with the purchaser and, technically, is the party that is responsible for reimbursing the purchaser. Under a Taxpayer obligor plan, Taxpayer is the party responsible for reimbursing the purchaser. When it is required by state law that a commercial insurance company be responsible for a dealer obligor contract, the contract is "insured" by Commercial IC, a stock nonlife insurance company and independent third party. Similarly, when required by state law, Taxpayer reinsures its Taxpayer obligor responsibilities pursuant to its vehicle protection contracts with Commercial IC.

The varying state law requirements result in four categories of vehicle protection contracts: (1) dealer obligor contracts "insured" with Commercial IC,[1] (2) dealer obligor contracts in which Taxpayer assumes and retains the insurance risks, (3) Taxpayer obligor contracts on which Taxpayer retains all of the insurance risks, and (4) Taxpayer obligor contracts in which Taxpayer has shifted the insurance risks over to Commercial IC. The latter three categories of contracts collectively will be referred to in this letter as the qualifying contracts. The receipts related to the qualifying contracts are approximately 75% of Taxpayer's vehicle protection contracts receipts and, in any event, receipts from these contracts are expected to remain significantly greater than 50% of total receipts from Taxpayer's vehicle protection contract program. Taxpayer also recognizes a small amount of income (less than 1% of its receipts of vehicle protection plans) from dividends, interest and capital gains. This income is primarily attributable to the holding of cash and marketable securities to meet its liabilities under the vehicle protection plans it issues.

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[1] Although all of the insurance risks in this first category of dealer obligor contracts ultimately reside in Commercial IC, these contracts are still administered through Taxpayer's vehicle protection plan program. Due to a number of factors, inter alia, uncertainty as to the state law characterization of the various relationships, we were unable to determine the precise nature of Taxpayer's role with respect to first category of dealer obligor contracts.

The price of any particular plan is negotiated between the automobile dealer and the purchaser. Taxpayer does not set the price at which the plan is ultimately sold to the purchaser. Taxpayer establishes a fixed cost that it charges the automobile dealer for each plan. The automobile dealer retains any amount charged the purchaser in excess of this fixed cost. The fixed cost includes an amount allocable to "insure" the plan and an amount allocable to administer the plan.

Funds are remitted by the automobile dealer to Taxpayer in either the full amount for which the vehicle protection plan was sold to the purchaser or the fixed cost charged the automobile dealer by Taxpayer. In the event the automobile dealer remits the full amount paid by the purchaser, Taxpayer issues a check to the dealer for any amounts in excess of the dealer's fixed cost for the vehicle protection plans sold. The issuance of these checks to the dealer is not necessarily done on an as sold basis, but rather is done at some regular interval such as monthly.

The purchaser of one of Taxpayer's vehicle protection plans follows certain procedures in order to make a proper claim. For example, the purchaser or representative of the repair facility contacts Taxpayer before any work is performed for authorization. Taxpayer makes a diagnosis and a determination of covered items, subject to the terms and conditions of the agreement. Taxpayer then issues an authorization number. After ensuring that the claim is complete, payment is made by Taxpayer to the agreement holder or the repair facility. Taxpayer's plan also contains an emergency road plan benefit. Under this feature a purchaser is provided an "888" telephone number, and certain minor repairs up to a cost of $50 per incident are provided. Taxpayer maintains an office staff in excess of x people in order to handle the administration of the vehicle protection plans it issues. Taxpayer does not, however, perform any of the repair services covered pursuant to these vehicle protection plans

Taxpayer has calculated reserves based upon claim statistics from thousands of fully earned out and expired service agreements. Taxpayer has established systems that allow it to track its claim experience by each type of service agreement that it offers or has offered in the past.[2]

LAW AND ANALYSIS

Section 831(a) of the Internal Revenue Code provides that taxes, as computed in § 11, are imposed for each taxable year on the taxable income of each insurance company other than a life insurance company.

Insurance companies subject to tax under § 831 of the Code are required to determine gross income under § 832(b)((1). Section 832(b)(1)(A) provides that one of the items taken into

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[2] This provides Taxpayer with statistics as to claim frequency and severity on a particular term (i.e., 12 months/12,000 miles; 24 months/24,000 miles, etc.), a particular level of coverage and a particular mileage band. For example, Taxpayer has provided an "Expired Agreements" report that shows the performance of over 105,000 fully earned agreements between Year 4 and Year 9.

account is the combined gross amount earned during the taxable year from investment income and from underwriting income computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. Section 832(b)(3) defines "underwriting income" as premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. Section 832(b)(4) provides that "premiums earned on insurance contracts during the taxable year" is the amount generally computed as follows: (1) from the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance; and (2) to the amount determine in (1) add 80% of the unearned premiums on outstanding business at the end of the preceding taxable year and deduct 80% of the unearned premiums on outstanding business at the end of the taxable year.

Section 1.831-3(a) of the Income Tax Regulations provides that, for purposes of §§ 831 and 832 of the Code, the term "insurance companies" means only those companies that qualify as insurance companies under the definition in former § 1.801-1(b) (now § 1.801-3(a)(1)) of the regulations.

Section 1.801-3(a)(1) of the regulations provides that, the term "insurance company" means 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. Section 1.801-3(a)(1) further provides that though the company's name, charter powers, and subjection to state insurance laws are significant in determining the business that a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year that determines whether the company is taxable as an insurance company under the Code. See also Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932) (to the same effect as the regulation); Rev. Rul. 83-172, 1983-2 C.B. 107 (holding that the taxpayer was an "insurance company," as defined in § 1.801-3(a)(1), notwithstanding that the taxpayer was not recognized as an insurance company for state law purposes).

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The accepted definition of "insurance" for federal income tax purposes related back to Helvering v. Le Gierse, 312 U.S. 531, 539 (1941), in which the Supreme Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." Case law has defined "insurance" as "involv[ing] a contract, whereby, for an adequate consideration, one party undertakes to indemnify another against a loss arising from certain specified contingencies or perils ... [I]t is contractual security against possible anticipated loss." See Epmeier v. United States, 199 F.2d 508, 509-510 (7th Cir. 1952). In addition, the risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir.), cert. denied, 439 U.S. 835 (1978).

Risk shifting occurs when a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer. See Rev. Rul. 92-93, 1992-2 C.B. 45, 45. If the insured has shifted its risk to the insurer, then a loss by the insured does not affect the insured because the loss is offset by the insurance payment. See Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. See Cloughtery Packing Co., 811 F.2d at 1300. When additional statistically independent risk exposures are insured, an insurance company's potential total loss increases, as does the uncertainty regarding the amount of that loss. See Rev. Rul. 89-61, 1989-1 C.B. 75. As uncertainty regarding the company's total loss increases, however, there is an increase in the predictability of the insurance company's average loss (total loss divided by the number of exposure units). Due to this increase in predictability, there is a downward trend in the amount of capital a company needs per risk unit to remain at a given level of solvency. See Rev. Rul. 89-61. See also Clougherty Packing Co., 811 F. 2d at 1300.

Based on the information submitted, we conclude that, for federal income tax purposes, the qualifying contracts are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the qualifying contracts are aleatory contracts under which Taxpayer, for a fixed price, is obligated to indemnify the purchaser or dealer for economic loss not covered by the manufacturer's warranty, arising from the mechanical breakdown of, and repair expense to, a purchased automobile. These contracts are not prepaid service contracts because Taxpayer does not provide any repair services. Further, by accepting a large number of risks, Taxpayer has distributed the risk of loss under the qualifying vehicle protection contracts so as to make the average loss more predictable.

Based on Taxpayer's representations concerning its business activities in providing the qualifying contracts, we find Taxpayer's "primary and predominant business activity" during 2000 was the issuing of the qualifying contracts, which we conclude are insurance contracts for federal income tax purposes. Thus, under § 1.801-3(a)(1) of the regulations, Taxpayer qualifies as an "insurance company" for purposes of § 831 of the Code.

CONCLUSIONS

(1) For 2000, the qualifying contracts (i.e., the dealer obligor contracts in which Taxpayer has assumed and retained the insurance risks, Taxpayer obligor contracts on which it retains all of the insurance risks and Taxpayer obligor contracts in which Taxpayer has reinsured the risks over to Commercial IC) are considered insurance contracts issued by Taxpayer for federal tax purposes.

(2) In 2000, Taxpayer is taxable under § 831(a) as an insurance company other than a life insurance company.

(3) In 2000, Taxpayer is entitled to deduct premiums paid to Commercial IC under the provisions of § 832(b)(4) with respect to "Taxpayer" obligor contracts whereby Commercial IC indemnifies it against losses under the provisions of § 832(b)(4).

In its September 20, 2000 letter, Taxpayer requested two additional rulings that relate to the deduction of unearned premium reserves and the §481(a) adjustment associated with its proposed change of method of accounting. We are not responding to those requests in this letter. While these are important questions to Taxpayer, they are more appropriately addressed during our consideration of Taxpayer's application for change in accounting method.

CAVEATS

(1) Except as expressly provided herein, no opinion is expressed concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. No opinion is expressed as to whether Taxpayer is the issuer of insurance contracts to the dealers under the dealer obligor plan which are fully covered by Commercial IC.

(2) No ruling has been requested, and no opinion is expressed, concerning whether Taxpayer's gross premiums written include the entire amount the purchasers of the vehicle protection contracts pay to the participating dealers for their contracts.

(3) No ruling has been requested, and no opinion is expressed, concerning what amount, if any, paid by the purchasers of the vehicle protection contracts, and retained by the participating dealers, is deductible as a commission expense by Taxpayer.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Provided the Internal Revenue Service approves Taxpayer's request to change its method of accounting for the transactions described in this letter, copies of this letter must be attached to the federal income tax returns of the taxpayers involved for the taxable year in which that change is effected.

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

Sincerely,
Acting Associate Chief Counsel
(Financial Institutions and Products)
By: Mark Smith
Chief, Branch 4