Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
July 9, 2001

Legend

Taxpayer =

Company X =

Company Y =

P =

Dear :

This is in response to your authorized representatives' submission of February 28, 2001, and subsequent submissions, requesting rulings that (1) certain extended service contracts sold 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 unaffiliated insurance company in connection with the transactions described below.

FACTS

Taxpayer is a wholly-owned subsidiary of company X. Company X is a wholly-owned subsidiary of company Y. Company Y is a wholly-owned subsidiary of P. P files a consolidated federal income tax return as the common parent of an affiliated group of corporations that includes Taxpayer and company X. P files its federal income tax return using the accrual method of accounting on a calendar year basis.

Taxpayer will issue and administer "Extended Service Contracts" ("ESC"s) to the purchasers of certain durable goods. These goods include automobiles and the plumbing, electrical, and heating systems in manufactured housing. ESCs will provide the purchaser with protection against economic loss resulting from the durable good's mechanical breakdown, so long as the loss is not covered by the manufacturer's warranty for the durable good. The entire business of Taxpayer will consist of the issuance and administration of ESCs.

ESCs will be structured in three forms: (1) Taxpayer as the administrator and obligor ("Taxpayer Obligor Contracts"), (2) Taxpayer as administrator and a participating dealer as the obligor ("Dealer Obligor Contracts"), and (3) Taxpayer as administrator and an independent insurance company as the obligor ("Insurance Company Obligor Contracts"). Under Insurance Company Obligor Contracts and Dealer Obligor Contracts, Taxpayer's only role is as administrator under the contracts. The Taxpayer represents that the predominant source of revenue collected by Taxpayer will be derived from the issuance of Taxpayer Obligor Contracts. No more than five percent of the premiums from Taxpayer Obligor Contracts will be attributable to any preventive maintenance.

The obligor under an ESC will be liable for specific costs of repair to covered goods. Most repairs are performed by the retail dealer that sold the durable good. Taxpayer does not perform any repairs.

The majority of ESCs will be sold to customers by independent dealers that have entered into dealer agreements with Taxpayer. These dealers will sell ESCs to the consumer for a negotiated price. The dealer then remits to Taxpayer a fixed amount per contract sold, and the dealer retains the balance as compensation for the sale.

Taxpayer will provide administrative services under the ESCs. Taxpayer will charge an administrative fee to the dealer or insurance company under Dealer Obligor Contracts and Insurance Company Obligor Contracts. Taxpayer will contract with various third party administrators to perform some or all of the necessary administrative functions such as claims processing and contract administration. Taxpayer will also purchase certain services from its affiliates. These services will include data processing, sales, accounting, and legal services. Under Dealer Obligor Contracts and Insurance Company Obligor Contracts, Taxpayer is not liable for any covered cost of repairs.

To comply with certain states' requirements, Taxpayer will purchase indemnity insurance (e.g., reimbursement insurance, surety insurance, etc.) from unaffiliated, licensed insurance companies to cover Taxpayer's obligations under the Taxpayer Obligor Contracts. Under these contracts, the third-party insurers agree to indemnify Taxpayer for some of the cost of claims made under the Taxpayer Obligor Contracts. Notwithstanding these contracts with third-party insurers, Taxpayer will remain directly liable to the purchasers of the Taxpayer Obligor Contracts.

LAW AND ANALYSIS

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

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 section 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 taxpayer was an “insurance company,” as defined in § 1.801-3(a)(1), notwithstanding that taxpayer was not recognized as an insurance company for state law purposes).

Neither the Code, nor the regulations thereunder, define the terms “insurance” or “insurance contract.” The accepted definition of "insurance" for federal income tax purposes relates back to Helvering v LeGierse, 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 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, 509-10 (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, as modified by Rev. Rul. 2001-31, 2001-26 I.R.B. (while parent corporation purchased a group-term life insurance from its wholly owned insurance subsidiary, this did not cause the arrangement to be “self-insurance” because the economic risk of loss was not that of parent). 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. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as a premium and set aside for the payment of such a claim. Insuring many independent risks in return for numerous premiums serves to distribute risk. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums. See Clougherty Packing Co., 811 F.2d at 1300.

Based on the information submitted, we conclude that, for federal tax purposes, the

Taxpayer Obligor Contracts are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the Taxpayer Obligor Contracts are aleatory contracts under which Taxpayer, for a fixed price, is obligated to indemnify the contract holder for economic loss, not covered by the manufacturer's warranty, arising from the mechanical breakdown of, and repair expense to, a durable good. Thus, the Taxpayer Obligor Contracts are not prepaid service contracts because Taxpayer's liability is limited to indemnifying the Taxpayer Obligor Contract holder for losses in the event a mechanical breakdown occurs. Taxpayer will not provide any repair services itself, no more than five percent of the premiums from Taxpayer Obligor Contracts will be attributable to any preventive maintenance provided by another entity, and Taxpayer will not provide for any reimbursement for any obligations that are properly the obligations either of dealers or independent insurance companies. In addition, by accepting a large number of risks, Taxpayer has distributed the risk of loss under the Taxpayer Obligor Contracts so as to make the average loss more predictable.

Based on Taxpayer's representations, we find Taxpayer's "primary and predominant business activity" is the issuing of Taxpayer Obligor Contracts, which we have just concluded are insurance contracts for federal 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.

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 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.

CONCLUSIONS

1. The Taxpayer Obligor Contracts are insurance contracts for federal tax purposes.

2. Taxpayer will be an insurance company within the meaning of section 831 and the regulations thereunder so long as its primary and predominant business consists the issuing of Taxpayer Obligor Contracts.

3. Taxpayer is entitled to deduct premiums paid to third-party insurance companies under

the provisions of § 832(b)(4) of the Code with respect to Taxpayer Obligor Contracts whereby the third-party insurance company indemnifies Taxpayer against losses under the provisions of § 832(b)(4) of the Code.

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.

2. No opinion is expressed concerning whether Dealer Obligor Contracts or Insurance Company Obligor Contracts are insurance contracts for federal tax purposes.

3. 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 Taxpayer Obligor Contracts pay to the participating dealers for their contracts.

4. No ruling has been requested, and no opinion is expressed, concerning what amount, if any, paid by the purchasers of the Taxpayer Obligor 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 the Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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 requesting 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 any income tax return to which it is relevant.

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