Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200242027**
Release Date: 10/28/2002
Index Number: 831.03-00

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:4-PLR-119045-02
Date:
July 17, 2002

Legend

Taxpayer =

State X =

Dealer =

Manager Corp. =

R Ins. Corp. =

m =

n =

Dear :

This is in response to your authorized representative's submission dated March 13, 2002, and subsequent submissions requesting rulings that (1) certain extended service contracts issued by, or ceded to, Taxpayer are insurance contracts for federal tax purposes and (2) that, for the 2002 calendar year, Taxpayer qualifies as an insurance company taxable under § 831 of the Internal Revenue Code.

FACTS

Taxpayer is incorporated in State X. Taxpayer is not licensed as an insurance company under the laws of State X. Taxpayer's stock is owned by four individual shareholders. The same four individuals also own Dealer in the same proportion of ownership that they own Taxpayer. Dealer is engaged in business as an automobile dealership company and is also incorporated under the laws of State X.

Taxpayer's business activities will consist of the issuance of three types of Automobile Service Contracts ("ASCs," collectively). Taxpayer will be the obligor for all ASCs. The daily business operations of Taxpayer will be managed by Manager Corp., an unrelated entity.

The ASCs will be marketed by Dealer, which sells new and used vehicles and parts, services new and used vehicles, and provides body shop services. The terms of the marketing relationship between Taxpayer and Dealer are governed by an agreement between the parties.

Upon the start of Taxpayer's business, certain existing ASCs and the related reserves will be ceded to Taxpayer by Manager. These ASCs had been warehoused by Manager. The terms of the warehousing arrangement were governed by an agreement between the Taxpayer and Manager.[1]

Taxpayer's business purpose for these transactions is to engage in the business of offering motor vehicle purchasers an opportunity to shift a material portion of their individual risk for certain expenses related to vehicle ownership. Each of the specific ASCs are described below.

The Motor Vehicle Service Contract ("MVSC") provides the purchaser with protection against economic loss for repair of the purchased motor vehicle for certain expenses caused by mechanical breakdown that are not covered by the manufacturer's warranty. The MVSC also covers a portion of (i) towing cost and (ii) replacement rental costs, associated with a mechanical breakdown. The MVSC does not cover incidental or consequential damages, such as property damage, personal injury, inconvenience, or loss of automobile use. Additionally, the MVSC does not cover preventative and routine maintenance.

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[1]According to a supplementary submission, the effective date of the ceding of these contracts from Manager to Taxpayer was April 30, 2002. Taxpayer represents that m MVSCs and TSCs were ceded to it by Manager. ("MVSCs" and "TSCs" are defined in the text, infra.)

The terms of the MVSCs provide that Taxpayer agrees to pay for the repair or replacement of any covered parts that are defective in materials or workmanship, except for the deductible, for the contract period. The contract period, which varies depending upon the coverage selected, is based upon a maximum period of time or a maximum number of miles driven, whichever occurs first. As indicated above, the terms of the MVSC do not cover parts that are covered by a manufacturer's warranty. Therefore, except for the coverage of certain towing and rental replacement costs, or those MVSCs that cover parts that are not covered by a manufacturer's warranty, liability under the MVSC does not arise until the manufacturer's warranty expires. Further, Taxpayer represents that none of the MVSCs issued by Taxpayer will cover payment for costs for which either the manufacturer or Dealer would be liable under warranties associated with the vehicle or other products sold.

Tire Service Contracts ("TSCs") are offered for both new and used vehicles. For new vehicles, a TSC covers the vehicle's tires, as listed in the validation section of the contract, for the usable tread life of the tire which becomes unserviceable as a result of a road hazard. The TSCs provide similar coverage for the tires of a used vehicle that are listed in the validation section of the contract. The TSCs provide that if a tire covered by the plan becomes unserviceable because of a road hazard during the usable tread life of the tire, the tire will be replaced with a comparable new tire. The TSC contract defines usable tread as the original tread depth less 2/32''. Mounting and balancing (if required) will be performed at no charge. When the tread is worn down to 2/32'' (to the tread wear indicators), the tire is considered worn out and the Plan ends regardless of the age of the tire.

Additionally, the TSCs do not cover incidental or consequential damages, such as property damage, personal injury, inconvenience, or loss of automobile use. Further, Taxpayer represents that none of the TSCs will cover payment for costs for which either the manufacturers or Dealer would be liable under warranties associated with the tires. Also, the TSCs do not cover preventative and routine maintenance.

Taxpayer represents that the price charged by Dealer for repair services to vehicles and tires under the MVSCs and the TSCs is the same as Dealer charges when it performs comparable work for unrelated parties, such as warranty work for unrelated companies.

The Preventative Maintenance Contract ("PMC"), provides for certain preventative and routine services (i.e., oil or other fluid changes, tune-ups, etc.), and similar services. The PMC does not cover incidental or consequential damages, such as property damage, personal injury, inconvenience, or loss of automobile use. Further, Taxpayer represents that none of the PMCs issued by Taxpayer will cover payment for costs for which either the manufacturer or Dealer would be liable under warranties associated with the vehicle or other products sold.

When Dealer sells a vehicle, it offers the purchaser of the vehicle any combination of the ASCs to limit the purchaser's exposure to the various types of risk and cost of ownership. Dealer is authorized to complete the form(s) provided by Taxpayer and to collect the "premium(s)" from the purchasers of the ASCs. For each ASC sold, Dealer remits a specific portion of the "premium" to Taxpayer and retains the balance.

Taxpayer provides no automotive services to the holders of the ASCs. It merely reimburses the service facility, or the holder of the ASC, for costs covered under the agreement. While the terms of the ASCs provide incentives for the vehicle owner to return to the selling dealership for service, under the terms of the contracts, the contract holder can choose the service facility. However, if the purchaser chooses a service facility other than Dealer, the purchaser must then have the problem diagnosed and receive approval for the cost of service from Manager prior to the start of any work.

In the event that a contract holder cancels coverage under one of the ASCs prior to its expiration date, Taxpayer will make a refund to the contract holder of the unexpired portion of the ASC premium, pursuant to a formula set forth in the ASC.

Additionally, Taxpayer has entered into a reinsurance agreement with R Ins. Corp., an unrelated licensed insurance company. Under the agreement, R agrees to indemnify Taxpayer in the event of bankruptcy. So long as Taxpayer is a going concern, it is anticipated that Taxpayer will retain the risk of loss for all ASCs issued.

Taxpayer represents that it anticipates that Dealer will sell n MVSCs and TSCs that are issued by Taxpayer per month in 2002. Additionally, over the next four years, Taxpayer plans to undertake an increasing amount of ASC business that Dealer is expected to produce for it. Other than Dealer allowing Taxpayer to incrementally write a greater portion of the ASC business that Dealer can produce, there are no written or unwritten agreements, understandings, etc. between Dealer and its shareholders with respect to Taxpayer's operations.

As stated above Taxpayer's business activities will consist of the issuance of the three types of ASC contracts. Additionally, Taxpayer will invest the funds it receives from issuing such contracts. Taxpayer represents that as of May 28, 2002 (the date of a supplemental submission), the charges from the sales of the PMCs are about 10 percent the total premiums and charges from the sales of the MVSCs , TSCs, and PMCs. Taxpayer represents that it is unlikely that the charges for PMCs will ever exceed 11 percent of total premiums and charges.

In connection with Taxpayer's investment activities, Taxpayer has contracted with a professional investment advisor to manage the investment of excess cash. The excess cash is determined on a monthly basis and is transferred to the investment advisor to invest. None of Taxpayer's employees has any daily responsibility for

overseeing investments. Taxpayer represents that its investment activities are, and will be, de minimis or incidental to its insurance activities.

REQUESTED RULINGS

1. The MVSC are insurance contracts for federal tax purposes.

2. The TSCs are insurance contracts for federal tax purposes.

3. Taxpayer will be taxable in 2002 under §831(a) as an insurance company other than a life insurance company, notwithstanding the sale of PMCs, because Taxpayer's primary and predominant business activity is the issuing of insurance contracts pursuant to § 1.801-3(a)(1) of the Income Tax Regulations.

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 § 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 Internal Revenue 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. 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 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 (while parent corporation purchased a group-term life insurance policy from its wholly owned insurance subsidiary, the arrangement was not held to be "self-insurance" because the economic risk of loss was not that of the parent), modified on other grounds, Rev. Rul. 2001-31, 2000-1 C.B. 1348. 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 smooths 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 MVSCs and the TSCs are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the MVSC and the TSCs are aleatory contracts, under which Taxpayer, for a fixed price, is obligated to indemnify the contractholder for economic loss, not covered by the manufacturer's warranty, arising from the mechanical breakdown of, and repair expense to, a purchased automobile or from damage to tire from road hazards. The 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 contracts so as to make the average loss more predictable.

Based on Taxpayer's representations concerning its business activities in 2002, we find Taxpayer's "primary and predominant business activity" during 2002 is the issuing of MVSCs and TSCs, 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" in 2002 for purposes of § 831 of the Code.

CONCLUSIONS

1. The MVSCs are insurance contracts for federal tax purposes.

2. The TSCs are insurance contracts for federal tax purposes.

3. Taxpayer qualifies as an "insurance company" in 2002 for purposes of § 831 of the Code.

CAVEATS

1. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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 MVSCs and the TSCs 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 MVSCs and the TSCs and retained by Dealer is deductible as a commission expense by Taxpayer.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to Taxpayer's federal income tax return for 2002.

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.

Sincerely,
MARK S. SMITH
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)