Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200416006**
Release Date: 4/16/04
Index Number: 832.00-00

Person To Contact:
, ID No. 50-07083
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Refer Reply To:
CC:FIP:4 – PLR-143639-03
Date:
January 6, 2004

Legend

Individual A =

Individual B =

Network =

State A =

State B =

Taxpayer =

Administrator =

Date m =

Year 1 =

Dear :

This is in reply to your letter of July 1, 2003, requesting rulings, principally, that the contracts issued by Taxpayer qualify as insurance contracts for federal income tax purposes and that Taxpayer is taxable under § 831 of the Internal Revenue Code as an insurance company other than a life insurance company.

FACTS

Individual A owns all the stock of the four of the seven auto dealerships within the Network, and Individual B owns all of the stock of the remaining dealerships. Beginning in Year 1, these dealerships sold vehicle service agreements in which the selling dealer was the primary obligor to the purchaser of the contract. Taxpayer, which was incorporated on Date m of Year 1, will be responsible for the issuance and administration of the vehicle service agreements issued to customers and will be the primary obligor on the agreements. In addition, Taxpayer states that it will assume for arms-length consideration, the outstanding risks on the dealer obligor vehicle service agreements issued by the individual dealers within the Network. All of the stock of Taxpayer is owed by Individual A.

The vehicle service agreements issued by Taxpayer provide purchasers with protection against economic loss for certain expenses related to the repair of vehicles not covered by the manufacturer's warranty. In the event that the manufacturer's warranty duplicates coverage under the contract, the contract will not apply and the vehicle owner can only recover under the manufacturer's factory warranty. The agreements under the vehicle service program typically cover repairs made necessary by the failure of major systems or components; but also include coverage of some incidental items caused by the failure of other components such as tire repair and replacement, lockout, and trip interruption. On the other hand, the agreements do not cover any preventative or routine maintenance such as engine tune ups, or oil or other fluid changes unrelated to a covered mechanical breakdown.

The vehicle service agreements on new vehicles are renewable in that a purchaser may purchase a vehicle service agreement for additional time and mileage provided the purchaser makes a request within 30 days and 1,000 miles prior to the expiration of the original agreement. On the other hand, the purchaser may cancel a vehicle service agreement contract and receive a refund of a portion of amounts paid as consideration for the agreement.

Taxpayer's only business activity is the issuance and administration of the vehicle service agreements offered by the Network whereby the selling dealer acts as Taxpayer's agent. Under the vehicle service agreements Taxpayer will be obligated to pay for the cost of labor and parts required for covered repairs, even though, Taxpayer does not perform any repairs.

While Taxpayer is not licensed as an insurance company under the laws of State A, other State A law and administrative practices regarding the sale of the contracts are applicable to Taxpayer. For example, State A law requires that the obligor of the contract such as Taxpayer must secure its obligations under the contract in an acceptable manner provided in the statute. Taxpayer will purchase indemnity insurance from a licensed insurance company, which, under the laws of State A, is one of the

accepted methods available to Taxpayer to secure its obligations. Under such an arrangement the contract obligor remains liable to the customer, but its obligations under the contracts are indemnified by the licensed insurer. Also, Taxpayer has entered into a program administration agreement with Administrator, an unrelated State B limited liability company whereby Administrator serves as program administrator for Taxpayer's business with respect to the contracts and will conduct many of the day-to-day record keeping and claims administration functions.

Taxpayer represents as follows:

(1) As permitted by State A law, Taxpayer will be the administrator and the named obligor on the vehicle agreements and is directly liable to the purchaser under the terms of the vehicle service agreements,

(2) The predominant source of revenue collected by Taxpayer will be derived from the issuance of vehicle service agreements with Taxpayer as obligor.

(3) Taxpayer does not perform any repair services covered pursuant to the vehicle service agreements.

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 § 832 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 determined 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 1.803-3(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 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 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 “involve[ing] a contract, whereby for valuable 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, as modified by Rev. Rul. 2001-31, 2001-1 C.B. 1348 (while parent corporation purchased a group-term life insurance policy 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 Cloughtery Packing Co., 811 F.2d at 1300.

Based on the information submitted, we conclude that, for federal income tax purposes, the vehicle service agreements are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the contracts are aleatory contracts under which Taxpayer, for a fixed price, is obligated to indemnify the purchaser of the contract for economic loss not covered by warranties provided by a manufacturer, arising from the mechanical breakdown of, and repair expense to, a purchased motor vehicle. Thus, the contracts are not prepaid service contracts because Taxpayer's liability is limited to indemnifying the vehicle service agreement contractholder for losses in the event a mechanical breakdown occurs. Taxpayer does not provide any repair services itself and does not provide reimbursement for any obligations that are properly the obligations of the manufacturer. Further, by accepting a large number of risks, Taxpayer has distributed the risk of loss under the vehicle service contracts so as to make the average loss more predictable.

Based on Taxpayer's representations concerning its business activities, we find Taxpayer's "primary and predominant activity," is issuing vehicle service agreements that are insurance contracts for federal income tax purposes. Thus, Taxpayer qualifies as an "insurance company" for purposes of § 831 of the Code.

CONCLUSIONS

(1) The vehicle service agreements issued by Taxpayer, as described above, are considered insurance contracts for federal tax purposes.

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

(3) Taxpayer is entitled under § 832(b)(4) to deduct premiums paid to a licensed insurance company for a contract protecting Taxpayer against losses incurred with respect to its obligations to purchasers under the Taxpayer's vehicle service agreements.

CAVEATS

(1) Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect 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 include the entire amount the purchasers of the vehicle service agreements pay to the dealers within the Network for their contracts.

(3) No opinion is expressed as to the federal tax treatment of the proposed arrangements whereby Taxpayer will assume the outstanding risks from the individual dealers in the Network that those dealers assumed under their respective dealer obligor contracts.

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.

The ruling is directed only to the taxpayer requesting it. Section 6110(k) of the Code provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

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

Sincerely,

/S/

THOMAS M. PRESTON
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)