Internal Revenue Service

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Person To Contact:
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Refer Reply To:
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PLR-136893-04
Date:
November 9, 2004

Company X =

Company Y =

Date 1 =

Dear

This is in reply to your letter of July 1, 2004, submitted by your authorized representative, requesting rulings that certain contracts proposed to be issued by Taxpayer will qualify as insurance contracts for federal income tax purposes.

FACTS

Company X files a consolidated federal income tax return as the common parent of an affiliated group of corporations that currently includes company X, company Y, and Dealers. Company X files its federal income tax return using the accrual method of accounting and a taxable year ending date 1.

Dealers are organized as corporations under the laws of their respective states and are taxable as C Corporations for federal income tax purposes. Dealers are engaged in the business of selling automobiles to their retail customers.

In connection with Dealers' automotive sales, Dealers will offer their customers vehicle service contracts ("Contracts") developed and marketed by Taxpayer. Taxpayer will be a newly formed corporation and a wholly-owned subsidiary of company Y. Taxpayer will join in the consolidated federal income tax return with company X, company Y, and Dealers. The Contracts will provide the purchaser of automobiles sold

by Dealers with protection against economic loss for certain expenses related to vehicle repair not covered by the manufacturer's warranty. The Contracts will also cover a portion of the replacement vehicle rental expense and towing and road service expense associated with a mechanical breakdown. The Contracts will not cover any preventative or routine maintenance, such as engine tune-up, suspension alignment, filters, or fluids. They also will not cover incidental or consequential damages, such as property damage, personal injury or loss of automobile use. The contract period will be based upon a maximum period of time or a maximum number of miles driven, whichever occurs first.

The business of Taxpayer will consist solely of issuing Contracts and performing services that consist primarily of premium, fee, and claims processing in conjunction with the Contracts as well as support services to assist in marketing the Contracts. The Taxpayer's entire allocated staff will be devoted to these functions, but the Taxpayer will also contract with an unrelated administrator to assist in providing policy agreement processing, adjusting services, and claim administration. Taxpayer will not provide any repair services to holders of the Contracts.

Upon sale of a Contract, the Dealers will collect the entire premium from the policyholder on behalf of Taxpayer and will remit a specific portion to Taxpayer and retain the balance as commission. Taxpayer will then reimburse the repairing facilities or the holder of the Contract for the costs covered in the Contract.

In the states it is permitted to do so, Taxpayer will be the sole obligor for each vehicle service contract that it issues. To comply with certain states= requirements, Taxpayer will enter into a contractual liability insurance policy with an unrelated insurance company ("IC") under which IC may become liable to the holder of the Contract if Taxpayer fails to perform under the terms of the Contract. IC may collect from Taxpayer any amount paid by IC pursuant to the contractual liability insurance policy. To provide additional security, IC will require Taxpayer to establish a trust account in which IC may draw upon in the event of a claim under the contractual liability policy. This trust would be permitted to invest only in cash or cash equivalents. Alternatively, IC will allow Taxpayer to provide a letter of credit in favor of IC.

LAW AND ANALYSIS

Section 831(a) 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 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 Aunderwriting income@ as premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. Section 832(b)(4) provides that Apremiums 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 831(c) provides that, for purposes of § 831, the term "insurance company" has the meaning given to such term by § 816(a).

Under § 816(a), the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

Neither the Code nor the regulations thereunder define the terms "insurance" or "insurance contract." The accepted definition of "insurance" for federal tax purposes is found in Helvering v. Le Gierse, 312 U.S. 531 (1941), in which the Supreme Court states that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." Id. at 539. Case law has defined an insurance contract as "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." Epmeier v. United States, 199 F.2d 508, 509-510 (7th Cir. 1952). In addition, the risk transferred under the contract must involve the assumption of another's risk of economic loss. Allied Fidelity Corp. v. Commissioner, 66 T.C. 1068 (1976), aff'd 572 F.2d 1190 (7th Cir. 1978), 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 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 income tax purposes, the Contracts are insurance contracts. The Contracts are aleatory contracts under which Taxpayer 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. 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 Contracts so as to make the average loss more predictable.

Based on Taxpayer's representations concerning its proposed business activities, we find that more than half of Taxpayer’s business will be the issuing of vehicle service agreements that are insurance contracts for federal income tax purposes. Thus, Taxpayer will qualify as an "insurance company" for purposes of § 831.

CONCLUSIONS

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

2. Taxpayer will be an insurance company within the meaning of § 831 so long as more than half of Taxpayer’s business during the taxable year consists of the issuing of Contracts.

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 Contracts pay to Dealers.

3. 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.

4. The ruling is directed only to the taxpayer requesting it. Section 6110(k) provides that it may not be used or cited as precedent.

5. 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)