Internal Revenue Service

Number: **200628004**
Release Date: 7/14/2006
Index Number: 831.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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, ID No.
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Refer Reply To:
CC:FIP:B04
PLR-125623-05
Date
April 10, 2006

Legend

Taxpayer =

Subsidiary =

State A =

State B =

Year 1 =

Plan A =

Plan B =

Plan C =

Number A =

Number B =

Number C =

Number D =

Number E =

Number F =

Number G =

Number H =

Percent X =

Dear

This letter is in response to the ruling request filed on behalf of Taxpayer, dated May 4, 2005, and supplemented by letters dated October 6, 2005, and November 1, 2005. The Taxpayer has requested rulings that 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

Taxpayer is a corporation chartered under the laws of State A. Taxpayer uses the calendar year as its taxable year and uses the accrual method of accounting for both financial reporting and federal income tax purposes.

Taxpayer's business is developing, marketing, and administering vehicle service protection plans. In Year 1, virtually all of Taxpayer's gross income came from the sale of Number A types of vehicle service protection plans. During Year 1, Percent X of Taxpayer's gross income was generated by three plans, Plans A, B, and C. Taxpayer anticipates that it will continue to earn more than half of its gross income from sales of these three plans in the future. Taxpayer is not a licensed or admitted insurer in State A.

Taxpayer wholly owns Subsidiary, a corporation chartered under the laws of State B. Subsidiary is a licensed insurer in State B.

Taxpayer does not directly sell vehicle service protection plans to its customers. Instead, vehicle dealers unrelated to Taxpayer and independent agents offer purchasers of new and used vehicles the opportunity to purchase Taxpayer's vehicle service protection plans. The vehicle dealers and independent agents collect the entire cost of the vehicle service protection plans from Taxpayer's customers, and then remit a portion of this amount (i.e., less a sales commission) to Taxpayer.

Taxpayer is the administrator of all the vehicle service protection plans it sells. When a customer has a loss covered by a vehicle service protection plan, Taxpayer is directly responsible for reimbursing the customer. When state law requires that a licensed commercial insurance company be the responsible party under the administrator obligor arrangement, Taxpayer enters into a Contractual Liability Protection agreement with a licensed commercial non-life insurance company unrelated to Taxpayer. Even in these situations, Taxpayer remains the administrator and bears the ultimate risk of loss under the contracts.

Regardless of whether Taxpayer contracts directly with a customer or reinsures a contract written by a licensed insurer, the customer follows the same procedures to make a claim. In general, prior to service at a repair facility, or in the case of a total loss, a customer or a representative of the customer contacts Taxpayer for authorization to perform the required work or to pay the claim. Taxpayer determines the validity of the claim within the terms and conditions of the arrangement between Taxpayer and the customer. Taxpayer then issues an authorization number. Once Taxpayer ensures that the claim is complete, Taxpayer makes payment to the customer or the customer's representative. Taxpayer does not perform any of the repair services covered.

Plan A is a total loss protection plan that covers the difference between the remaining balance on a vehicle's finance contract and the amount that an unrelated insurance company pays on a total loss of the vehicle if such loss is less than the remaining finance balance. Plan A offers coverage up to Number B dollars or Number C percent of the manufacturer's suggested retail price, and also covers up to Number D dollars in insurance deductibles. In general, Plan A can be cancelled within Number E days for a full refund, or after Number E days for a pro rata refund. Taxpayer reinsures Plan A contracts with an A+ rated licensed insurance company unrelated to Taxpayer.

Plans B and C are vehicle theft protection plans. Plans B and C provide a limited benefit of up to Number F or Number G dollars (depending on the level of protection purchased) if the vehicle is stolen and declared a total loss. Plans B and C cannot be cancelled. Plans B and C also include a service that involves etching permanent identification numbers on certain vehicle equipment and parts. The value of this etching is nominal, whether compared to the premiums collected or the benefits paid out under Plans B and C.

Taxpayer represents that it enters into more than Number H contracts for its plans with unrelated customers every year.

LAW AND ANALYSIS

Section 831(a) of the Internal Revenue Code provides that taxes, as computed under § 11, will be imposed on the taxable income (as defined by § 832) of each insurance company other than a life insurance company. Section 831(c) defines the term “insurance company,” for purposes of that section, in the same manner as that term is defined under § 816(a). Section 816(a) provides that 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.

Section 1.831-3(a) of the Income Tax Regulations provides that, for purposes of §§ 831 and 832, 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).)

Section 1.801-3(a)(1) 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); Rev. Rul. 83-172, 1983-2 C.B. 107 (holding that 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). To qualify as an insurance company, a taxpayer “must use its capital and efforts primarily in earning income from the issuance of contracts of insurance.” Indus. Life Ins. Co. v. United States, 344 F. Supp. 870, 877 (D.S.C. 1972), aff’d per curiam, 481 F.2d 609 (4th Cir. 1973).

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The United States Supreme Court, however, has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531 (1941). 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. . . It is contractual security against possible anticipated loss.” 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). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F. 2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. LeGierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs if 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, 2001-1 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 premiums and set aside for the payment of such a claim. 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.

The “commonly accepted sense” of insurance derives from all of the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that of known insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of an arrangement under the applicable state law, AMERCO, Inc. v. Commissioner, 96 T.C. 18, 41 (1991); the adequacy of the insurer’s capitalization and utilization of premiums priced at arm’s length, The Harper Group v. Commissioner, 96 T.C. 45, 60 (1991), aff’d 979 F.2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728 (1991), aff’d per curiam, 988 F.2d 1134 (Fed. Cir. 1993); and the language of the operative agreements and the method of resolving claims, Kidde Indus. Inc. v. United States, 49 Fed. Cl. 42, 51-52 (1997).

A contract providing benefits in kind, rather than in cash, may constitute an insurance contract for federal income tax purposes. Commissioner v. W.H. Luquire Burial Ass’n Co., 102 F.2d 89, 90 (5th Cir. 1939); § 1.213-1(e)(4).

In the present case, Plan A customers shift to Taxpayer their economic risk upon the total loss of their vehicle. The benefits paid to Plan A customers are measured by the difference, or gap, between the remaining principal balance on the vehicle's finance contract and the amount that an unrelated insurance company pays on a total loss of the vehicle, if such loss is less than the remaining finance balance. Even though this "gap" exceeds the fair market value of the vehicle, it is an economic cost the customer must bear in the event of a total loss. Taxpayer represents that all states consider Plan A to be insurance.

Plans B and C customers likewise receive benefits under their contracts reimbursing them for economic loss in the event their insured vehicle is stolen.

Plans A, B and C shift from customers to Taxpayer the economic risk that will result if the insured vehicles are stolen or experience a total loss. By accepting premiums from a large number of customers, and paying out benefits to those customers whose vehicles are stolen or experience a total loss, Taxpayer distributes the risk of loss under the contracts. The law of large numbers thus operates so as to make the average loss more predictable.

Amounts received under Plans A, B and C represent Percent X of Taxpayer's gross income, a number significantly greater than 50%. Developing, marketing, and administering these and other plans accounts for virtually all of Taxpayer's business activities.

RULING

For federal income taxes purposes, Taxpayer is an insurance company taxable under § 831(a) of the Internal Revenue Code. Plans A, B, and C are insurance contracts for federal income tax purposes.

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. No ruling has been requested, and no opinion is expressed, concerning whether Taxpayer’s other plans qualify as insurance contracts for federal income tax purposes, or whether gross premiums written under Plans A, B and C include the amounts retained by the selling dealerships. No opinion is expressed concerning the purpose and motive of the transaction or the application of §§ 482 or 845 to the transaction. No ruling has been requested, and no opinion is expressed, concerning § 1361.

The ruling contained in this letter is 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.

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 any income tax return to which it is relevant.

Sincerely,

/S/

Mark Smith
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)