Internal Revenue Service

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Department of the Treasury
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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
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Date:
April 25, 2007

Legend

Taxpayer =

Parent =

Investors =

State =

Insurance Company =

X =

Y =

Z =

Date A =

Date B =

Date C =

Dear

This responds to your letter dated December 22, 2006, and subsequent information provided on April 18, 2006, requesting a ruling that: (1) the vehicle service contracts (VSCs) issued by Taxpayer are insurance contracts for federal income tax

purposes, and (2) Taxpayer qualifies as an insurance company under section 831(a) of the Internal Revenue Code (Code).

FACTS

Taxpayer is a corporation organized under the laws of State. Taxpayer is not regulated as an insurance company under the laws of State. Taxpayer presently files its federal income tax return on a calendar year basis and uses the accrual method of accounting. On Date A, Investors purchased Taxpayer, along with several affiliated companies, and reorganized them so that they are now controlled by Parent. Thus, starting with the short accounting period beginning Date B and ending Date C, Taxpayer will join in the filing of a consolidated return with Parent. For its short taxable year, Taxpayer intends to file a Form 1120-PC.

Taxpayer represents that its sole business activity is the issuance and administration of VSCs for pre-owned vehicles. Unrelated automobile dealers sell Taxpayer's VSCs to their customers at a negotiated price when they sell a vehicle that qualifies for such coverage. The dealer collects the total contract price from the purchaser (contract holder); remits a fixed amount to Taxpayer; and retains the balance as a commission. Taxpayer presently markets and distributes its VSCs in this way with approximately X automotive dealerships located in Y states. In the 2006 short taxable year, Taxpayer issued Z VSCs.

The VSCs indemnify the contract holder against economic loss for certain expenses to repair a vehicle that has had a mechanical breakdown, provided the expenses are not covered by either the manufacturer or a dealer's warranty. In addition, the VSCs may offer limited coverage for a portion of the costs of roadside assistance that are necessitated by a mechanical breakdown. The VSCs do not cover a contract holder's expenses for preventative or routine maintenance, and they limit the amount payable per repair to the cash value of the vehicle at the time of the repair.

Taxpayer does not perform any automobile repair services. Instead, Taxpayer pays the contract holder for any necessary repairs based upon the coverage terms of the VSC after the repairs have been made and the claim has been closed.

Taxpayer is the obligor on all of the VSCs it issues. In states that require that companies that sell VSCs to obtain insurance from a licensed insurance company, Taxpayer has entered into a contractual liability protection policy with Insurance Company to insure its performance under the VSCs. Under the policy, Taxpayer's obligations are indemnified by the licensed insurance company, but Taxpayer remains liable to the contract holder.

LAW AND ANALYSIS

Section 831(a) provides that taxes, as computed in section 11, will be imposed on the taxable income (as defined by section 832) of each insurance company other than a life insurance company. Section 831(c) defines the term "insurance company," for purposes of the section, as having the same meaning as that term is given under section 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 sections 831 and 832, the term "insurance companies" means only those companies that qualify as insurance companies under the definition of former section 1.801-1(b) (now section 1.801-3(a)(1)).

Section 1.801-3(a)(1) provides that although 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 Internal Revenue 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 taxpayer was an insurance company as defined in section 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), cert. denied, 414 U.S. 1143 (1974). To determine whether a taxpayer qualifies as an insurance company, all relevant facts will be considered, including but not limited to, the size and activities of its staff, whether it engages in other trades or businesses, and its sources of income. See generally, Bowers, 285 U.S. 182; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92 (N.D. Tex. 1969), rev'd on other grounds, 293 F.2d 72 (8th Cir. 1961); Inter-Am. Life Ins. Co. v. Commn'r, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1971); Nat'l Capital Ins. Co. of the Dist. of Columbia v. Commn'r, 28 B.T.A. 1079, 1085-86 (1933).

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. 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. Commn'r, 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. Le Gierse, 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 (when 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. Commn'r, 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. 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 can smooth 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 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. Commn'r, 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. Commn'r, 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); section 1.213-1(e)(4).

Based on the information submitted, we conclude that Taxpayer's VSCs are insurance contracts for federal income tax purposes. The VSCs are aleatory contracts under which Taxpayer, for a fixed price, is obligated to indemnify the contract holder for

certain economic losses, which are not covered by the manufacturer or a dealer's warranty, that result from the vehicle's mechanical breakdown. Thus, during the contract period, the contract holder has limited its loss for covered risks to the payment of the contract purchase price. In this way, each contract holder has shifted its risk of economic loss to the Taxpayer. By issuing VSCs to a large number of contract holders, Taxpayer has assumed numerous, independent, and homogeneous risks. In this way, Taxpayer has distributed the risk of loss under the VSCs so as to make the average loss more predictable.

Based upon Taxpayer's represents concerning its business activities, we find that more than half of Taxpayer's business is issuing VSCs that are insurance contracts for federal income tax purposes. Therefore, Taxpayer will qualify as an "insurance company" for purposes of section 831.

CONCLUSIONS

(1) Taxpayer's VSCs, as described above, are insurance contracts for federal tax purposes.

(2) Taxpayer will be taxable as an insurance company under section 831(a) as long as more than half of its business consists of issuing the VSCs.

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.

The rulings contained in this letter are based upon the information and representations submitted by 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. Code section 6110(k)(3) 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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to the first listed representative.

Sincerely,

/S/

Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
Office of Assistant Chief Counsel
(Financial Institutions & Products)