Internal Revenue Service

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Person To Contact:
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Date:
November 05, 2007

LEGEND:

Taxpayer:
EIN:

State A:

State B:

State C:

Individual:

Number 1:

Number 2:

Number 3:

Number 4:

Number 5:

Number 6:

Number 7:

Number 8:

Amount:

Dear :

This responds to your letter dated July 3, 2007, requesting a ruling that: (1) the extended service agreements (ESAs) issued by Taxpayer are insurance contracts for federal tax purposes, and (2) Taxpayer qualifies as an insurance company under section 831(a) of the Internal Revenue Code (Code).

Individual owns a controlling interest in Number 1 entities. Number 2 of those entities each own an automobile dealership. Number 3 entity is a holding company that owns all of the ownership entities in Number 4 entities, each of which separately own an automobile dealership. Individual has Number 8 percent ownership of one of the dealerships and the holding company. Individual owns Number 5 percent of the ownership interest in another dealership and Number 6 percent of the ownership in Number 7 of the remaining dealerships. The dealerships are located in State A, State B, and State C.

Taxpayer is a corporation organized under the laws of State A. Taxpayer will not be licensed as an insurance company in States A, B, and C, the states in which it will issue ESAs. In order to comply with state law in State A and State B, Taxpayer will insure its obligations under the ESAs with an unrelated commercial insurer. Taxpayer will also insure its obligations under ESAs issued in State C even though State C law may not require such insurance.

Taxpayer is currently negotiating the purchase of an insurance policy from a commercial insurance company. To obtain this policy, Taxpayer will have to have an initial capital of approximately Amount 1. Taxpayer anticipates that Individual will provide the initial capital. Additionally, Taxpayer will be required to either maintain loss reserves in a trust account or establish a line of credit in the amount specified by the commercial insurance company. The commercial insurance company will also require Taxpayer to follow an investment policy that restricts the investment of loss reserves. If Taxpayer is unable to obtain an insurance policy from this commercial insurer, it expects to obtain an insurance policy from another commercial insurance company with similar security requirements. Taxpayer represents that more than half of its business will constitute the issuance of ESAs.

The ESAs will indemnify the ESA holder against economic loss for certain repair expenses resulting from vehicle breakdowns, but only if the expenses are not covered by the manufacturer's warranty. Under certain circumstances, the ESAs will also indemnify the ESA holder against part of the cost of towing and substitute transportation necessitated by the vehicle breakdown. The ESAs will be offered both for new and used cars sold by Individual's dealership, as well as other dealerships.

The ESAs will not indemnify the contract holder for any of the following: (1) expenses related to routine or preventive maintenance, such as oil changes and other periodic services; (2) losses normally covered by casualty insurance, including losses attributable to accidents, floods, fire, and vandalism; (3) losses attributable to improper use of the vehicle, e.g. commercial use; (4) incidental and consequential damages attributable to improper use of the vehicle, e.g. commercial use; (5) incidental and consequential damages attributable to vehicle breakdown, except for part of the cost of substitute transportation and towing. Additionally, the ESAs limit the aggregate amount payable under the contract to the price paid for the vehicle.

The customer will select from available options the maximum months and the maximum mileage covered by the ESA. The available options will depend on the vehicle's make, model and type (i.e. new or used). The term of the ESA will end upon the earlier of the expiration of its maximum number of months or miles.

For repairs to be covered under the ESA, the ESAs generally will require the ESA holder to return to the selling dealership to have the repairs made. The ESAs, however, will permit the ESA holder to take the vehicle to another repair facility (1) for emergency repairs, as defined in the ESAs; or (2) if the vehicle is located more than forty miles from the selling dealership, or the selling dealership has moved, and the ESA holder obtains authorization. The price that the dealership will charge for repairs under the ESAs will be the same as that charged for comparable work performed by unrelated parties.

When the dealership sells an ESA, it will collect the full purchase price and remit a predetermined portion to Taxpayer or to an unrelated administrator hired by Taxpayer, retaining the rest as commission. If the dealership remits the purchase price to an administrator, the administrator will deduct an administrative fee and remit the remainder to Taxpayer. Otherwise, Taxpayer will pay the administrative fee after it receives payment from the dealership. When the ESA holder obtains covered repairs, Taxpayer will reimburse either the repair facility or the ESA holder. Additionally, Taxpayer may make payments to affiliated entities for management, administrative, and/or other services.

If the covered vehicle is repossessed or declared a total loss or if an ESA holder cancels the ESA prior to its expiration date, Taxpayer will issue a refund. Generally, the amount of the refund is determined by a formula, and represents the unexpired portion of the purchase price. When permitted by state law, Taxpayer will deduct a small administrative fee.

Taxpayer's business will consist of issuing ESAs. Taxpayer may perform services related to the ESAs such as processing fees, tracking claims, investing premiums and assisting the dealerships in marketing the ESA contracts. Taxpayer will not perform any repair services. Taxpayer expects for each year in which it operates, its gross receipts from issuing ESAs will constitute a substantial majority of its gross receipts.

LAW AND ANALYSIS

Section 831(a) provides that taxes, as computed under 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 the 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 section 831 and 832, the term "insurance company" 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. 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. Commissioner, 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. Commissioner, 28 B.T.A. 1079, 1085-86 (1933).

Neither the Code nor the regulations thereunder define the term "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 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. 1978), 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, 290-291 (2d Cir. 1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 89-96, 189-2 C.B. 114, as amplified by Rev. Rul. 2007-47, 2007-30 I.R.B. 127.

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 risk of economic 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 as premiums and set aside for the payment of such 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. v. Commissioner, 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 known insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of an arrangement under the applicable state law. AMERCO 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 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 ESAs are insurance contracts for federal income tax purposes. The ESAs 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's or 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 the risk of economic loss to the Taxpayer. By issuing ESAs to a large number of contract holders, Taxpayers will assume numerous, independent, and homogenous risks. Taxpayer will have distributed the risk of loss under the ESAs so as to make the average loss predictable.

Based upon Taxpayer's representation concerning its business activities, we find that more than half of Taxpayer's business will be issuing ESAs 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 ESAs, as described above, are insurance contracts for federal income tax purposes.

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

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

The rulings contained in this letter are base upon the 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.

The 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,

Sheryl B. Flum
SHERYL B. FLUM
Chief, Branch 4
Office of Assistant Chief Counsel
(Financial Institutions & Products)