Internal Revenue Service

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Taxpayer =
Parent= =
Date A =
Contracts =

Year B =
Number C =
Number D =
Agreement: =

Company E =
Number F =
Number G =

Dear :

This responds to your representative's letter of May 7, 2008, requesting rulings under part I of subchapter L of the Internal Revenue Code.

Facts

Taxpayer represents as follows:

Taxpayer is a wholly owned subsidiary of Parent. Parent operates as a third party administrator providing various services related to the administration of "vehicle service contracts" (also known as "extended warranty contracts") issued by unrelated insurance companies.

Beginning around Date A, Taxpayer began issuing vehicle service contracts ("Contract(s)"). The Contracts provide the holder with protection against economic loss

for certain expenses related to vehicle repair not covered by the manufacturer's warranty. The Contracts also cover a portion of the replacement vehicle rental expense and towing and road service expense incurred as a result of a covered breakdown. The Contracts do no cover any preventative or routine maintenance, such as engine tune-up, suspension alignment, filters, or fluids. The Contracts do not cover incidental or consequential damages. Taxpayer does not perform any repair services but rather only reimburses repair facilities or the holder of the Contract. The Contracts' coverage period is the first occurring of a stated time or miles driven. In the event a holder cancels the Contract prior to its expiration, Taxpayer is obligated to refund to the holder the unearned premium in an amount determined under the formula specified in the Contracts.

The Contracts are sold by retail automobile dealers. Upon the sale of a Contract, the dealer collects the full premium charge and remits a predetermined portion to Taxpayer with the balance being the dealer's commission. As of the end of Year B, Taxpayer had in force approximately Number C Contracts and anticipates issuing in excess of Number D Contracts per year.

Taxpayer has entered into an agreement ("Agreement") with unrelated Company E whereby Company E agrees to indemnify Taxpayer for 100% of claims made under the Contracts. The Agreement is in accordance with the applicable state law requirements and is treated as an insurance contract for such purposes.

Taxpayer has entered into an arrangement with Parent whereby Parent will perform services for Taxpayer related to the administration of the Contracts.

In addition to the Contracts, Taxpayer administers certain other products; the percentage of Taxpayer's revenue derived from the Contracts exceeds Number F % and that derived from the other administrative services is less than Number G %.

Law and Analysis

Requested Ruling #1

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. LeGierse, 312 U.S. 531, 539 (1941), in which the 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 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).

Cases analyzing "captive insurance" arrangements have distilled the concept of "insurance" for federal income tax purposes to three elements, applied consistently with principles of federal income taxation:[1] 1) involvement of an insurance risk; 2) shifting and distribution of that risk; and 3) insurance in its commonly accepted sense. See, e.g., AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g 96 T.C. 18 (1991).

Insurance risk involves 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; see also Rev. Rul. 2007-47.

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, 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 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; Rev. Rul. 2005-40, 2005-2 C.B. 4.

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., 96 T.C. at 41; 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, 55 (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 1135 (Fed. Cir. 1993); and the language of the

[1] These principles include respecting the separateness of corporate entities, the substance of the transaction(s), and the relationship between the parties. Sears, Roebuck and Co. v. Commissioner, 96 T.C. 61, 101-02 (1991), aff'd, 972 F.2d 858 (7th Cir, 1992).

operative agreements and the method of resolving claims, Kidde Indus. Inc. v. Commissioner, 49 Fed. Cl. 42, 51-52 (1997).

The Contracts are aleatory contracts under which Taxpayer, for a fixed price, is obligated to indemnify the holder for economic loss not covered by the manufacturer's warranty, arising from the mechanical breakdown of, and repair expense to, a vehicle. The plans are not prepaid service contracts because Taxpayer does not perform any repair services. By accepting a large number of risks, Taxpayer has distributed the risk of loss under the Contracts.

Accordingly, we conclude that the Contracts constitute insurance contracts for federal income tax purposes.

Requested Ruling #2

Under § 831(c), the term "insurance company" has the meaning given to such term by § 816(a). Section 816(a) provides that the term "insurance company" means any company more than half 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.

Based on the representations concerning its business activities, we conclude that Taxpayer will qualify as an insurance company under § 831(c) for any taxable year in which more than half of its business is the issuing of the Contracts.

Requested Ruling #3

Reinsurance is commonly thought of as

> a contract whereby one insurer transfers or 'cedes' to another insurer all or part of the risk it has assumed under a separate or distinct policy or group of policies in exchange for a portion of the premium. In essence, reinsurance is insurance for insurance companies.

COUCH ON INSURANCE § 9:1 (2008). And this view of reinsurance has been shared in the context of litigation concerning federal income taxes. See, e.g., Colonial Am. Life Ins. Co. v. Commissioner, 491 U.S. 244, 246-47 (1989).

Here, the Agreement has all the hallmarks of a reinsurance treaty and as such constitutes reinsurance for federal income tax purposes and should be accounted for under part II of subchapter L accordingly.

Rulings

We rule that:

1. that the Contracts constitute insurance contracts for federal income tax purposes;
2. that Taxpayer qualifies as an insurance company under § 831(c); and
3. that the Agreement constitutes a reinsurance contract for federal income tax purposes.

The rulings contained in this letter are 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.

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.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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.

Sincerely,

/S/

Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)