Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Date:
October 19, 2009

Legend

Taxpayer:
A:
State B:
Year X:

Dear :

This is in response to your authorized representative's submission dated April 30, 2009, and subsequent submissions requesting rulings that: (1) certain extended service contracts issued by Taxpayer during Year X, and that Taxpayer expects to continue issuing, are insurance contracts for federal tax purposes; and (2) beginning on January 1, Year X, Taxpayer qualifies as an insurance company taxable under the provisions of I.R.C. § 831.

FACTS

Taxpayer is incorporated in State B. Taxpayer is not licensed as an insurance company under the laws of State B. Taxpayer's stock is wholly owned by an individual. The same individual also wholly owns and operates A. Taxpayer directly issues and administers motor vehicle service contracts (“MVSC”). In addition, Taxpayer administers extended service contracts (“ESC”). Taxpayer’s business consists solely of its activities related to the MVSCs and ESCs. The services performed by the Taxpayer include warranty administration, claims administration and adjusting functions. A markets both ESCs and MVSCs to independent automobile dealers in several states.

Under the MVSCs, Taxpayer directly contracts with vehicle purchasers providing coverage for mechanical failures. The purpose of the MVSC is to provide the auto purchaser with protection against economic loss for repair resulting from the mechanical breakdown of covered parts. The MVSCs provide that for the contract period, the Taxpayer must pay the cost in excess of any deductible to repair and/or replace any covered parts that are defective in materials or workmanship. The contract period depends upon the coverage purchased and is the lesser of the term or the elapsed vehicle mileage. The MVSCs do not cover parts already covered by existing manufacturer's warranties.

MVSCs are sold by auto dealers to vehicle purchasers at the time of purchase. The premiums on the MVSCs are collected by the auto dealers at the time of purchase and remitted to the Taxpayer.

The ESCs are written in a standard form whereby the auto dealer acts as the principal and obligor. Under the ESCs, the auto dealer is required to indemnify the purchaser for costs of automobile breakdowns if the mechanical breakdowns are caused by the failure of covered parts in normal use and for which the original manufacturer's warranty does not cover repair. Purchasers are not required to have repairs performed by the selling auto dealer.

The ESCs are not separately stated from the total purchase price of the vehicle. Rather, the ESCs are sold and included in the total cost of the vehicle. After execution of the agreement between the auto dealer and purchaser, the auto dealer assigns the contract to Taxpayer. A predetermined amount of the final purchase price of the automobile is remitted to the Taxpayer to be held in a loss reserve fund to secure performance of Taxpayer's obligations.

Taxpayer provides no automotive services to the holders/purchasers of either the MVSCs or ESCs.

Taxpayer represents that for the period ended June 30, Year X, more than 50% of the Taxpayer's business is related to the sale of MVSCs. Taxpayer further represents that similar growth is expected for the remainder of Year X and for future periods thereafter. Taxpayer has accepted a large number of risks for Year X and expects to continue accepting similar risks for future periods. The number of risks Taxpayer accepts depends on the number of MVSCs sold. Accepting a large number of risks will enable Taxpayer to use the law of large numbers so as to make its average loss statistically more predictable.

Taxpayer will invest the premiums it receives from the sale of MVSCs. Taxpayer anticipates utilizing professional investment advisors to manage the investment of any excess cash. Taxpayer represents that its investment activities are, and will be, de minimis or incidental to its insurance activities.

REQUESTED RULINGS

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

2. The ESCs are insurance contracts for federal tax purposes.

3. Taxpayer will be taxed as an insurance company under section 831.

LAW AND ANALYSIS

I.R.C. § 831(a) provides that taxes, as computed in I.R.C. § 11, will be imposed on the taxable income of each insurance company other than a life insurance company.

I.R.C. § 831(c) provides that, for purposes of I.R.C. §§ 831 and 832, the term "insurance companies" means only those companies that qualify as insurance companies under the definition in former Treas. Reg. § 1.801-1(b) [now Treas. Reg. § 1.801-3(a)(1)].

Treas. Reg. § 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. Treas. Reg. § 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) (to the same effect as the regulation); Rev. Rul. 83-172, 1983-2 C.B. 107 (holding taxpayer was an "insurance company," as defined in Treas. Reg. § 1.801-3(a)(1), notwithstanding that taxpayer was not recognized as an insurance company for state law purposes).

Neither the Internal Revenue 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. Commissioner, 572 F.2d 1190, 1193 (7th Cir.), 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 smooths 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 tax purposes, the MVSCs are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the MVSCs are aleatory contracts. Under the MVSCs, Taxpayer, for a fixed price is obligated to indemnify the vehicle purchaser for economic loss not covered by the manufacturer's warranty arising from the mechanical breakdown of, and repair expense to, a purchased automobile. The contracts are not prepaid service contracts because Taxpayer does not provide any repair services. 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.

We further conclude that, for federal tax purposes, the ESCs are not insurance contracts because they do not reinsure risks underwritten by an insurance company.

Based on the Taxpayer's representations concerning its business activities, we find that Taxpayer's “primary and predominant business activity” up to June 30, Year X is the issuing of MVSCs, which we have just concluded are insurance contracts for federal tax purposes. As represented by Taxpayer, similar growth is expected for the remainder of Year X and for future periods. If at the end of Year X more than 50% of taxpayer’s business is related to MVSCs, Taxpayer will under Treas. Reg. § 1.801-3(a)(1) qualify as an “insurance company” in Year X for purposes of I.R.C. § 831.

Prior to filing a Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return, Taxpayer must submit a Form 3115, Application for Change in Accounting Method. If Taxpayer desires to file a Form 1120-PC for Year X, its Form 3115 should be filed before the end of Year X.

CONCLUSIONS

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

2. The ESCs are not insurance contracts for federal tax purposes.

3. If more than 50% of Taxpayer's business for Year X is related to MVSCs, Taxpayer will qualify as an "insurance company" in Year X for purposes of I.R.C. § 831.

CAVEATS

1. 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.

2. No ruling has been requested, and no opinion is expressed, concerning whether Taxpayer's gross premiums written include the entire amount the purchasers of the MVSCs pay to the participating dealers for their contracts.

3. No ruling has been requested, and no opinion is expressed, concerning what amount, if any, paid by the purchasers of the ESCs and MVSCs and retained by auto dealers is deductible as a commission expense by Taxpayer.

This ruling is directed only to the taxpayer(s) 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 Taxpayer's federal income tax return for Year X.

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.

Sincerely,

/S/

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

cc: