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Person To Contact:
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Date:
December 19, 2012

Taxpayer =

Country X =
Date X =
Date Y =
Obligor 1 =
Obligor 2 =
Parent =
State X =
State Y =
State Z =
Subsidiary =
Z =

Dear :

This is in response to the letter submitted by your authorized representatives, dated August 20, 2012, requesting rulings on the federal income tax treatment of the contracts and entities described below, and related rulings, under Part II of Subchapter L of the Internal Revenue Code of 1986 (the “Code”).

I. FACTS

Taxpayer

Taxpayer is a corporation chartered under the laws of State X. Taxpayer is a wholly-owned subsidiary of Parent, which was formed under the laws of Country X. Taxpayer is the parent of an affiliated group of corporations that file a consolidated federal income tax return.

Taxpayer is the majority owner of Subsidiary. Subsidiary is a member of Taxpayer's consolidated group. Subsidiary provides customer financing and performs other functions in support of Taxpayer's wholesale auto sales business. Subsidiary's various departments and functions currently include commercial credit, consumer credit, servicing, collections, business systems, risk, finance, legal, compliance, human resources, sales and marketing, and administration.

Subsidiary is the parent of two wholly-owned subsidiaries: Obligor 1 and Obligor 2. Obligor 1 is a corporation that was chartered under the laws of State Y on Date X. Obligor 1 is a member of Taxpayer's consolidated group. Obligor 2 is a corporation that was chartered under the laws of State Z on Date Y. Obligor 2 is a member of Taxpayer's consolidated group. Neither Obligor 1 nor Obligor 2 will have any employees. Obligor 1 and Obligor 2 will each enter into an agreement with Subsidiary whereby Subsidiary will render administrative and support services to Obligor 1 and Obligor 2 with respect to the Contracts, described below, in exchange for a fee.

Contracts

Obligor 1 and Obligor 2 will be principally engaged in the issuance of contracts that provide financial protection against economic loss for certain expenses related to vehicle repair not covered by the vehicles' manufacturer's warranties (the "Contracts"). Taxpayer anticipates that for each year that Obligor 1 or Obligor 2 is in business, the Obligor Company's gross receipts derived from issuing the Contracts will comprise a substantial majority, at least Z%, of the Obligor Company's total gross receipts. Each Obligor Company will account of the Contract premiums received, related unearned premiums and loss reserves, and other items of income and deductions as an insurance company.

The Contracts provide protection to the vehicle purchaser or lessee for the economic loss associated with the cost of repairs due to a mechanical breakdown over a contractually defined period, which is based on length of time or vehicle mileage. The period covered by the Contract is based on the first occurring of a stated time or miles driven. The Contracts also cover a portion of the replacement vehicle rental expense in certain cases and towing associated with a mechanical breakdown. The Contracts will not cover any preventative or routine maintenance. The Contracts will not cover incidental or consequential damages. If a policyholder of a Contract cancels a Contract prior to its expiration, the issuing Obligor Company will be obligated to refund to the policyholder of the Contract the unearned premium in an amount determined under the Contract.

Obligor 1 and Obligor 2 will be the issuers and named obligors on the Contracts, and will be directly liable to the policyholders of the Contracts. Obligor 1 and Obligor 2 will not act as the obligors on any new product warranties, and will not cover any of the costs under such warranties. Obligor 1 and Obligor 2 will not perform any repair services. Instead, Obligor 1 and Obligor 2 will reimburse repair facilities or the policyholders of the Contracts for the costs of covered repairs.

The Contracts will be sold to policyholders by unrelated retail automobile dealers (the "Agents"). Upon the sale of a Contract by an Agent, the Agent will collect a "Purchase Premium" from the policyholder and remit a predetermined portion of the Purchase Premium, the "Agent Cost," to the issuing Obligor Company. For each Contract sold, the Agent will retain a commission, the "Agent's Commission," equal to the different between the Purchase Premium and the Agent Cost.

Certain states in which Obligor 1 and Obligor 2 will issue the Contracts require an issuer of such Contracts to obtain a contractual liability insurance policy ("CLIP") or surety bond, to insure that the issuer performs its obligations under the Contracts. Taxpayer represents that the CLIPs will be in accordance with the applicable state law requirements and will be treated as insurance contracts for such purposes. Obligor 1 and Obligor 2 will obtain the CLIPs or surety bonds from an unrelated insurance company.

II. ADDITIONAL REPRESENTATIONS

In addition to the facts and representations presented above, Taxpayer has also made the following representations:

1. Obligor 1 and Obligor 2 will be licensed as vehicle service contract providers in their respective states, State Y and State Z, for purposes of issuing the Contracts.
2. Obligor 1 and Obligor 2 will not be licensed insurers, will not be regulated as insurance companies under state law, and are not required to be regulated as insurance companies under state law.
3. The Obligor Companies anticipate issuing a sufficient number of Contracts to unrelated third parties so that the law of large numbers applies and risk distribution is achieved.

III. LAW AND ANALYSIS

Insurance Contacts and Insurance Company Status

Section 831(a) provides that taxes, computed as provided in § 11, are imposed for each taxable year on the taxable income of every insurance company other than a life insurance company. Section 831(c) treats the term "insurance company" for purposes of § 831 as having the same meaning as that term is given 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.

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 dates 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, 509-510 (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). Cases analyzing "captive insurance" arrangements have described the concept of "insurance" for federal income tax purposes as containing three elements: (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, 164-165 (9th Cir. 1992), aff'g 96 T.C. 18 (1991).

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. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

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 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 curium, 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).

We conclude that, for federal tax purposes, the Contracts are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the Contracts are aleatory contracts. Under the Contracts, Obligor 1 or Obligor 2 for a fixed price is obligated to indemnify the policyholder for economic loss not covered by the manufacturer's or other warranty arising from the mechanical breakdown of, and repair expense to, a purchased or leased automobile. The Contracts are not prepaid service contracts because neither Obligor 1 nor Obligor 2 provides any repair services. Further, by accepting a large number of risks, Obligor 1 and Obligor 2 have distributed the risk of loss under the Contracts so as to make the average loss more predictable.

Provided that at the end of each taxable year, more than 50% of the business of Obligor 1 is issuing the Contracts, Obligor 1 will qualify as an insurance company for that taxable year for purposes of § 831. Provided that at the end of each taxable year, more than 50% of the business of Obligor 2 is issuing the Contracts, Obligor 2 will qualify as an insurance company for that taxable year for purposes of § 831.

Gross Premiums Written

In the case of an insurance company taxable under § 831, the term "taxable income" means the gross income as defined in § 832(b)(1) less the deductions allowed in § 832(c). Section 832(b)(1)(A) provides that the term "gross income" includes the combined gross amount earned during the taxable year from investment income and from underwriting income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. Section 832(b)(3) provides that the term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

Section 832(b)(4) provides, in relevant part, that the term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

(A) From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance.

(B) To the result so obtained, add 80 percent of the unearned premiums on outstanding business at the end of the preceding taxable year and deduct 80 percent of the unearned premiums on outstanding business at the end of the taxable year.

Gross premiums written are amounts payable for insurance coverage. The label placed on a payment in a contract does not determine whether an amount is a gross premium written. Gross premiums written include all amounts payable for the effective period of the insurance contract. Treas. Reg. § 1.832-4(a)(4).

For purposes of computing each Obligor Company's insurance company taxable income under § 832, the gross premiums written on a Contract is the Purchase Premium paid by the policyholder for the Contract.

Expenses Incurred

Expenses incurred, for purposes of determining a nonlife insurance company's underwriting income under § 832(b)(3), means all expenses shown on the annual statement approved by the NAIC. § 832(b)(6). Expenses incurred do not include amounts which are not allowed as deductions under § 832(c). § 832(b)(6). Under § 832(c)(1), a nonlife insurance company may deduct all ordinary and necessary expenses incurred, as provided in § 162 (relating to trade or business expenses). Expenses incurred for a taxable year are computed as follows: "To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year." § 832(b)(6).

The Agents' Commissions are a deductible expense that are a form of policy acquisition expense. See H.R. Conf. Rep. No. 99-841, at 354 (1986). Accordingly, for purposes of computing each Obligor Company's insurance company taxable income under § 832, each Obligor Company may deduct its Agents' Commissions paid during the taxable year in accordance with § 832(b)(6).

IV. HOLDINGS

Based on the information submitted and Taxpayer's representations:

1. The Contracts issued by the Obligor Companies will constitute insurance contracts for federal income tax purposes.
2. Provided that at the end of each taxable year, more than 50% of the business of Obligor 1 is issuing the Contracts, Obligor 1 will qualify as an insurance company for that taxable year for purposes of § 831. Provided that at the end of each taxable year, more than 50% of the business of Obligor 2 is issuing the Contracts, Obligor 2 will qualify as an insurance company for that taxable year for purposes of § 831

3. For purposes of computing each Obligor Company's insurance company taxable income under § 832, the gross premiums written on a Contract is the Purchase Premium paid by the policyholder for the Contract.
4. For purposes of computing each Obligor Company's insurance company taxable income under § 832, each Obligor Company may deduct its Agents' Commissions paid during the taxable year in accordance with § 832(b)(6).

This ruling does not address the reinsurance of any of the risks discussed in this ruling. See Treas. Reg. §§ 1.832-4(a)(8)(i); 1.832-4(a)(10) Ex. 9.

Except as expressly provided herein, no opinion is expressed concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. The rulings contained in this letter are based upon 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 who requested 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 representatives.

Sincerely,

DONALD J. DREES, JR.
Senior Technician Reviewer, Branch 4
Office of the Associate Chief Counsel
(Financial Institutions & Products)

cc: