Internal Revenue Service

Number: **201419007**
Release Date: 5/9/2014

Index Number: 831.03-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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, ID No.

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Refer Reply To:
CC:FIP:B04
PLR-133991-13

Date:
January 29, 2014

Legend

Taxpayer =

State N =

Dear :

This is in response to the letter submitted by your authorized representatives requesting a ruling that certain contracts are insurance contracts and that Taxpayer's wholly-owned subsidiary corporation qualifies as an insurance company for federal income tax purposes.

FACTS

Taxpayer is a partnership organized under the laws of State N and is taxable as a partnership for federal income tax purposes. Taxpayer is engaged in the business of selling equipment to commercial customers.

Taxpayer represents as follows:

Taxpayer is forming a wholly-owned subsidiary corporation ("Newco"). In connection with Taxpayer's sales of this equipment, Newco will develop and market an extended warranty contract program. Through the program, Newco will offer to Taxpayer's customers extended warranty contracts ("Extended Warranties") on parts that are in the equipment. The Extended Warranties are not included in the sales price of the equipment. Taxpayer's customers will have the option of buying an Extended Warranty for a specified price. Newco will perform premium, fee, and claims processing services in conjunction with the Extended Warranties as well as support services to assist in

marketing the Extended Warranties. Taxpayer will collect the premiums of the Extended Warranties sold to its customers as agent for Newco, and Newco will be the sole obligor under the Extended Warranties.

The Extended Warranties will provide a customer with protection against economic loss for the replacement or repair related to specified parts not covered by the manufacturer's warranty for a specified duration. The parts covered under the Extended Warranties will not be manufactured by Taxpayer, Newco, or any other affiliate of Taxpayer and neither Taxpayer nor any of Taxpayer's affiliates will have control over the manufacturing process. The Extended Warranties will not cover any preventative or routine maintenance, will not cover incidental or consequential damages, such as property damage, and will not cover freight or labor.

More than half of Newco's business is the issuing of the Extended Warranties.

REQUESTED RULINGS

1. The Extended Warranties constitute insurance for federal income tax purposes.
2. Newco will qualify as an insurance company within the meaning of § 831 of the Internal Revenue Code.

LAW AND ANALYSIS

Section 831(a) provides that taxes, computed as provided in § 11, are imposed for each taxable year on the taxable income of each insurance company other than a life insurance company. Section 831(c) provides that, for purposes of § 831, the term "insurance company" has the meaning given to such term by § 816(a). Under § 816(a), the term "insurance company" means "any company more than half the business of which during the taxable year is issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies."

Newco's qualification as an insurance company for federal income tax purposes therefore depends on whether its primary and predominant activity constitutes issuing of insurance contracts.

Neither the Code nor the regulations define the terms "insurance" or "insurance contract" for federal income tax purposes. The standard for evaluating whether an arrangement constitutes insurance for federal tax purposes has evolved over the years and is, at best, a nonexclusive facts and circumstances analysis. Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 861-64 (7th Cir. 1992). The most frequently cited opinion on the definition of insurance is Helvering v. LeGierse, 312 U.S. 531 (1941), in which the Court describes "insurance" as an arrangement involving risk-shifting and risk-distributing of an "insurance risk" determined at the time the transaction was executed. 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 distributing 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). The test, however, is not a rigid three-prong test.

The risk transferred must be a risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 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. LeGierse, 312 U.S. at 542; Rev. Rul. 2007-47, 2007-2 C.B. 127; Rev. Rul. 89-96, 1989-2 C.B. 114. In addition, the arrangement must constitute insurance in the commonly accepted sense.

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, such that a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer. 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. 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. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

Courts have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. Humana v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989). See also Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135, 1153 ("Risk distribution involves spreading the risk of loss among policyholders."); Beech Aircraft Corp. v. U.S., 797 F.2d 920, 922 (10th Cir. 1986) ("[R]isk distributing means that the party assuming the risk distributes his potential liability, in part, among others.") Thus, purported insurance arrangements that involve an issuer who contracts with only one policyholder do not qualify as insurance contracts for federal income tax purposes. Rev. Rul. 2005-40.

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, AMERICO, Inc., 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 1135 (Fed. Cir. 1993); and the language of the

operative agreements and the method of resolving claims, Kidde Indus. Inc. v. Commissioner, 40 Fed. Cl. 42, 51-52 (1997).

In order to determine the nature of an arrangement for federal income tax purposes, it is necessary to consider all the facts and circumstances in a particular case, including not only the terms of the arrangement, but also the entire course of conduct of the parties. Thus, an arrangement that purports to be an insurance contract but that lacks the requisite insurance risk, or fortuity, may instead be characterized as a deposit arrangement, a loan, a contribution to capital (to the extent of net value, if any), an option or indemnity contract, or otherwise, based on the substance of the arrangement between the parties. The proper characterization of the arrangement may determine whether the issuer qualifies as an insurance company and whether amounts paid under the arrangement may be deductible.

Under the Extended Warranties, Newco assumes the risk of economic loss from the customers for the cost of repairs of specified equipment. Customers have the option not to purchase an Extended Warranty. Customers can also choose to purchase an extended warranty contract from a different company. The amounts paid by the customers to purchase an Extended Warranty are pooled. The effect is to shift to Newco the risk of loss from the purchasers of the Extended Warranties and distribute this risk among the customers participating in the program. The risk of loss which is shifted to Newco is an insurance risk and the coverage provided to the purchasers is in accord with the commonly accepted sense of insurance.

RULINGS

1. The Extended Warranties constitute insurance contracts for federal income tax purposes.
2. Newco qualifies as an insurance company for federal income tax purposes provided its business activity is consistent with Taxpayer's representation that more than half of Newco's business is the issuing of the Extended Warranties.

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) of the Code provides that it may not be used or cited as precedent.

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,

John E. Glover
Senior Counsel, Branch 4
(Financial Institutions & Products)