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Person To Contact:
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Telephone Number:

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Parent =

Subsidiary =

Obligor1 =

Obligor2 =

Reinsurer =

State W =
State X =
State Y =
State Z =
Branded Motor Vehicles =

Dear :

This letter is in response to the request submitted by your authorized representative for rulings on the federal income tax treatment of certain contracts under Part II of Subchapter L of the Internal Revenue Code.

FACTS

Parent, a State W corporation, is the parent of an affiliated group of corporations that files a consolidated federal income tax return. Parent and some of its subsidiaries manufacture, import, and distribute Branded Motor Vehicles for sale and lease in the United States.

Subsidiary, a State X corporation, is Parent's wholly-owned financing subsidiary. Subsidiary has historically offered a variety of vehicle protection products, primarily vehicle service contracts (VSCs), that motor vehicle dealers ("Dealers") may sell to purchasers and lessees ("Consumers") of new and used Branded Motor Vehicles. These products, including the VSCs, are offered at an additional cost to Consumers. Currently, Subsidiary receives an administrative fee for each VSC sold, but does not assume any risk of loss under the VSC. Instead, an unrelated third party serves as the contract obligor for all VSCs.

For business reasons, including the ability to control Consumers' "brand experience" and to earn underwriting profits, Subsidiary intends to move to a new business model in which risk assumed under the VSCs and similar contracts will be retained with Parent's consolidated group. As part of this new business model, Subsidiary formed Obligor1, a State Y corporation, as a wholly-owned subsidiary. Obligor1 then formed Obligor2, a State Z corporation, and Reinsurer, a State Y corporation, as wholly-owned subsidiaries. Obligor1 and Obligor2 (collectively "the Obligors") are not regulated as insurance companies by their respective states of domicile, but Reinsurer will be regulated as an insurance company under State Y law.

Before the commencement of business operations, Subsidiary will contribute cash to the Obligors and Reinsurer in excess of the state minimum capital requirements. In addition, at all times, the Obligors and Reinsurer will hold more than sufficient cash and assets to satisfy state regulatory requirements and to provide for operating expenses.

Obligor1 will be the obligor on the VSCs that Dealers sell to Consumers in several states except State Z. Obligor2 will be the obligor on the VSCs that Dealers sell to Consumers in State Z.

The VSCs to be issued by the Obligors provide Consumers with financial protection against economic loss for certain repair costs by covering the cost of repairs or by reimbursing Consumers for the cost of parts and labor to repair or replace covered parts. The VSCs also cover a portion of towing costs, incidental extra expenses related to trip disruption, and costs of rental replacement automobile. The VSCs do not cover incidental or consequential damages such as property damage, personal injury, inconvenience, or loss of vehicle use.

The VSCs are not prepaid service contracts; the VSCs do not cover routine preventive maintenance nor do the Obligors provide repair services under the VSCs. The VSCs will not reimburse Consumers for any costs that are covered by a manufacturer's warranty. However, if a VSC covers a cost that is also covered by a manufacturer's warranty or any other service or recall program, and the coverage under the warranty or other program is less than the coverage provided by the VSC, the VSC will pay the

excess of the amount the VSC covers over the amount paid under the warranty or other program.

Purchasing a VSC is optional and the Dealer and the Consumer separately negotiate the VSC's purchase price. Regardless of the purchase price, the Dealer must remit a set amount to the appropriate Obligor for each VSC sold. The Consumer selects the VSC period -- maximum months and the maximum mileage -- under the contract. If a Consumer cancels VSC coverage prior to the VSC's expiration date, the Obligor will pay a pro-rata refund of the VSC purchase price (including a refund from the portion retained by the Dealer) to the Consumer, less a processing fee and the amount of any claims paid.

Under the new business model, an unrelated corporation ("Administrator") will administer the VSCs that the Obligors will issue. The Administrator will prepare weekly claims paid and claims pending reports; supply forms, advertising and promotional materials; and investigate and process all claims presented under the VSCs.

To protect Consumers purchasing the VSCs, some states will require Obligor1 to purchase a contractual liability insurance policy from an unrelated insurance company pursuant to which the unrelated insurance company stands ready, under certain conditions, to provide the Consumers the benefits under the VSCs.[1] In addition, Obligor1 will cede most of the risk assumed under the VSCs to Reinsurer under a quota share indemnity reinsurance arrangement. In other states in which Obligor1 does business, Obligor1 will cede all of the risks assumed under the VSCs to an unrelated insurance company that, in turn, will retrocede all of the risk to Reinsurer.[2] In the remaining states in which Obligor1 does business, Obligor1 - and in State Z, Obligor2 - will enter a quota share indemnification agreement with Reinsurer pursuant to which, in exchange for a transfer by each Obligor of a portion of the payments the Obligor will receive for the VSCs, Reinsurer will indemnify the Obligor for the related portion of contract losses and expenses, but the Obligor will remain directly liable to the Consumer for all VSC benefits. The quota share indemnity reinsurance agreements between each Obligor and Reinsurer (and between Obligor1 and unrelated insurer) will be priced at arm's length.

In addition to the VSCs, the Obligors may make available other vehicle protection products which do not qualify as insurance for federal tax purposes (i.e., prepaid maintenance contracts). However, more than half of each Obligor's business during the taxable year will be the issuance of VSCs. The Obligors will not insure risks originating with their corporate affiliates or shareholders.

[1] Obligor1 will also fund a custodial account on behalf of the contractual liability insurance policy that is held by the unrelated insurance company.
[2] Obligor1 will also fund a trust account to be held by the unrelated insurance company.

For federal income tax purposes, each Obligor will account for the VSC premiums it receives, the related unearned premiums and loss reserves, and other items of income and deductions in accordance with § 832.

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 every insurance company other than a life insurance company. Section 831(c) defines 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 term "insurance" or "insurance contract" for federal income tax purposes. In the seminal case addressing this subject, the United States Supreme Court reasoned that in order for a transaction to qualify as insurance

> the amounts must be received as a result of a transaction which involved an actual 'insurance risk' at the time the transaction was executed. Historically and commonly insurance involves risk-shifting and risk-distributing . . . That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators.

Helvering v. Le Gierse, 312 U.S. 531, 539 (1941). Subsequent cases, in analyzing whether premiums paid to captive insurance companies are deductible, have considered whether the transaction constitutes insurance in its "commonly accepted sense" and whether the risk transferred is an "insurance risk" to establish a framework for determining whether an arrangement will be respected as insurance for Federal tax purposes. R.V.I. Guaranty Co., LTD v. Commissioner, 145 T.C. 209, 224-25 (2015). See also, Rent-A-Center, Inc. v. Commissioner, 142 T.C. 1, 13-14 (2014) (risk shifting, risk distribution, insurance risk, commonly accepted notions of insurance are four nonexclusive criteria establishing framework for determining insurance for Federal tax purposes).

In addition case law has described "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). Courts

consider "all of the facts and circumstances to determine whether an arrangement qualifies as insurance." Rent-A-Center, 142 T.C. at 22 (citing Harper Group, 96 T.C. at 57).

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. 2005-40, 2005 C.B. 4, 7. 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. Id.

To determine whether an arrangement constitutes insurance in its commonly accepted sense, factors to consider are: (1) whether the insurer is organized, operated, and regulated as an insurance company by the States in which it does business; (2) whether the insurer is adequately capitalized; (3) whether the insurance policies are valid and binding; (4) whether the premiums are reasonable in relation to the risk of loss; and (5) whether premiums are duly paid and loss claims are duly satisfied. R.V. I. Guaranty Co., Ltd, 145 T.C. at 231; Rent-A-Center, 142 T.C. at 24-25 (adequate capitalization, organization and operation as an insurance company, valid and binding policies, charged and received actuarially determined premiums, and paying claims indicative of the commonly accepted sense of insurance).

We conclude that, for federal tax purposes, the VSCs are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the VSCs are aleatory contracts. Under the VSCs, for a fixed price each Obligor is obligated to indemnify the Consumer 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 VSCs are not prepaid service contracts because neither Obligor1 nor Obligor2 provide any repair services.

Through Dealers' sales, each Obligor will issue VSCs to a substantial number of individual Consumers and the VSCs will cover a substantial number of new and used Branded Motor Vehicles. Therefore, the risks will be distributed across a large number of insureds. Further, by accepting a large number of risks, the average risk of loss of each Obligor under the VSCs is more predictable.

In addition to having insurance risk, risk shifting, and risk distribution, based on the facts described above, the arrangement constitutes insurance in its commonly accepted sense.

HOLDINGS

Based on the information submitted and Taxpayer's representations:

1. The VSCs issued by each Obligor will constitute insurance contracts for federal income tax purposes.

2. Provided that at the end of each taxable year more than half of each Obligor's business is issuing the VSCs, each Obligor will qualify as insurance company for that taxable year for purposes of § 831.

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. This office has not verified any of the material submitted in support of the request for rulings, and 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,

Rebecca L. Baxter
Rebecca L. Baxter
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)