Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Date:
July 21, 2000

Legend

Taxpayer =

Parent =

State =

Y =

s =

t =

u =

v =

w =

x =

y =

z =

Dear :

This is in response to your authorized representatives' submission dated January 13, 2000, and subsequent submissions requesting rulings that (1) certain extended service contracts ("Company Obligor Contracts") issued by Taxpayer are insurance contracts for federal tax purposes and (2) that, for the Y calendar year, Taxpayer

qualifies as an insurance company taxable under § 831 of the Internal Revenue Code.[1] This ruling request is being made at the request of the Service in connection with Taxpayer's timely filed Form 3115, Application for Change in Accounting Method, for Y.

FACTS

Taxpayer is a corporation organized under the laws of State. Taxpayer is not recognized as an insurance company under the laws of State.

Taxpayer is a wholly-owned subsidiary of Parent. Parent files a consolidated federal income tax return as the common parent of an affiliated group of corporations that includes Taxpayer. Taxpayer filed its federal income tax return for years prior to Y using the accrual method of accounting on a calendar year basis.

In general, Taxpayer is in the business of issuing and administering (1) service contracts that provide automobile purchasers with financial protection against mechanical breakdown or failure of certain parts and systems of their vehicles and (2) contracts that provide the automobile purchasers with prepaid maintenance services for their automobiles. Taxpayer's business operations are described in more detail below.

Company Obligor Contracts. A Company Obligor Contract provides the purchaser protection against economic loss for certain expenses related to mechanical breakdown and repair of the purchased automobile that are not covered by the manufacturer's warranty. A Company Obligor Contract also covers a portion of (i) towing costs, (ii) replacement rental costs, and (iii) food and lodging (under certain limited circumstances), but it does not cover incidental or consequential damages, such as property damage, personal injury, inconvenience, or loss of automobile use.

Company Obligor Contracts are sold through automobile dealers that have entered into Administrative Agreement Contracts with Taxpayer ("participating dealers"). When an automobile is purchased from a participating dealer, the dealer may offer the purchaser a Company Obligor Contract to supplement the manufacturer's warranty. Participating dealers are authorized to complete the forms provided by Taxpayer and to collect the sales proceeds from the purchasers of Company Obligor Contracts. For each Company Obligor Contract sold, the dealer remits a specified portion of the sales proceeds to Taxpayer and retains the balance.

Taxpayer does not perform any repairs. Usually, a purchaser will obtain repair services from the dealer that sold him or her the covered automobile and accompanying Company Obligor Contract. However, under the Administrative

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[1] Taxpayer originally requested additional rulings, but has withdrawn those ruling requests.

Agreement Contract between Taxpayer and a participating dealer, the participating dealer agrees to make any repairs covered under a Company Obligor Contract that are preapproved by Taxpayer, whether or not the dealer sold the particular Company Obligor Contract. Taxpayer is obligated, under an Administrative Agreement Contract, to reimburse a participating dealer for any preapproved costs of repairs covered under a Company Obligor Contract.

In order to comply with requirements imposed by state laws, Taxpayer enters into contracts and pays amounts to third-party insurance companies, which are licensed under state law. Under these contracts, the third-party insurers agree to indemnify Taxpayer for some of the cost of claims made under the Company Obligor Contracts. Notwithstanding these contracts with third-party insurers, Taxpayer remains directly liable to the purchasers of Company Obligor Contracts.

Dealer Obligor Contracts. Some states require that a dealer be directly liable to the purchaser under an extended warranty contract. In these states, participating dealers sell extended warranty contracts ("Dealer Obligor Contracts") under which they are directly liable to the purchaser for the cost of repairs and parts not covered by the manufacturer's warranty, and the dealers obtain insurance coverage to indemnify themselves for their expenses under these contracts from third-party insurers through Taxpayer. In exchange for an administrative fee from the dealer, Taxpayer administers the dealer's Dealer Obligor Contracts under the terms of its Administrative Agreement Contract with the dealer. Under the terms of the Dealer Obligor Contracts, Taxpayer does not assume or incur any liability to the automobile purchaser.

Prepaid Maintenance Contracts. Taxpayer, through its participating dealers, sells prepaid maintenance contracts that provide for a scheduled number of services to be performed by the dealers to a purchased automobile upon the redemption by the purchaser of service coupons that are provided to the purchaser at the time the contract is acquired. Under the Administrative Agreement Contracts, the participating dealers receive a commission for selling prepaid maintenance contracts on behalf of Taxpayer. Under the Administrative Agreement Contracts, Taxpayer agrees to reimburse the dealers for maintenance services they perform upon redemption of the service coupons.

Taxpayer makes the following representations concerning its business activities for Y. The sale of Company Obligor Contracts produced gross revenue of $x, which Taxpayer characterizes as “gross premiums written.”[2] Taxpayer paid $y to third-party insurers to indemnify its expenses under these contracts, which Taxpayer characterizes as “reinsurance premiums.” The sale of Prepaid Maintenance Contracts produced gross revenue of $z. Taxpayer derived $w of gross income attributable to its role as the

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[2] The $x received from the sale of Company Obligor Contracts that Taxpayer characterizes as “gross premiums written” includes the amounts retained by the participating dealers, which are characterized as “commissions” by Taxpayer.

administrator of Dealer Obligor Contracts. Taxpayer reported investment income of $t. Finally, Taxpayer's "losses incurred," within the meaning of § 832(b)(5) of the Code, were $s.

Thus, for Y, over u percent of Taxpayer's gross income is attributable to gross revenue from the sale of Company Obligor Contracts and over v percent of Taxpayer's gross income is attributable to gross revenue from the sale of such contracts after payments to third-party insurers are taken into account.

LAW AND ANALYSIS

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

Section 1.831-3(a) of the Income Tax Regulations provides that, for purposes of §§ 831 and 832 of the Code, the term "insurance companies" means only those companies that qualify as insurance companies under the definition in former § 1.801-1(b) (now § 1.801-3(a)(1)) of the Regulations.

Section 1.801-3(a)(1) of the Regulations 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. Section 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 § 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, 45. 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. See Clougherty Packing Co., 811 F.2d at 1300. When additional statistically independent risk exposures are insured, an insurance company's potential total loss increases, as does the uncertainty regarding the amount of that loss. See Rev. Rul. 89-61, 1989-1 C.B. 75. As uncertainty regarding the company's total loss increases, however, there is an increase in the predictability of the insurance company's average loss (total loss divided by the number of exposure units). Due to this increase in predictability, there is a downward trend in the amount of capital a company needs per risk unit to remain at a given level of solvency. See Rev. Rul. 89-61. See also Clougherty Packing Co., 811 F.2d at 1300.

We conclude that, for federal tax purposes, the Company Obligor Contracts are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the Company Obligor Contracts are aleatory contracts under which Taxpayer, for a fixed price, is obligated to indemnify the contractholder 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 Company Obligor Contracts so as to make the average loss more predictable.

Based on Taxpayer's representations concerning its business activities in Y, we find Taxpayer's "primary and predominant business activity" during Y was the issuing of Company Obligor Contracts, which we have just concluded are insurance contracts for federal tax purposes. Thus, under § 1.801-3(a)(1) of the Regulations, Taxpayer qualifies as an "insurance company" for purposes of § 831 of the Code.

CONCLUSIONS

1. The Company Obligor Contracts are insurance contracts for federal tax purposes.

2. In Y, Taxpayer is taxable under § 831(a) as an insurance company other than a life insurance company.

CAVEATS

1. 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.

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 Company Obligor Contracts 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 Company Obligor Contracts, and retained by the participating dealers, is deductible as a commission expense by Taxpayer.

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.

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.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,
Acting Associate Chief Counsel (Financial Institutions and Products)

By: |S|
Mark S. Smith
Chief, Branch 4