INTERNAL REVENUE SERVICE
UIL Nos. 831.03-00
832.00-00
Number: **199903024**
Release Date: 1/22/1999

CC:DOM:FI&P:4/PLR-113280-98
October 27, 1998

Parent =

S-1 =

S-2 =

A =

Date B =

State C =

State D =

State E =

State F =

x =

y =

Date G =

usage units =

r =

s =

Dear

This responds to your June 5, 1998 letter requesting a ruling that a corporation providing coverage for a manufactured product against mechanical breakdown, beyond the protection afforded by the manufacturer's warranties, will be treated as an insurance company for federal income tax purposes. You also requested a ruling that the amounts paid as premiums by such corporation to an insurance company including an affiliated insurance company may be deducted under § 832(b)(4) of the

Internal Revenue Code. Additional information was submitted in letters dated August 12, September 3, September 8, and September 23, 1998.

Parent, a publicly held domestic corporation, is engaged in the manufacture and sale of As worldwide. Nearly all of the As are sold to independently owned and operated dealers located throughout the world.[1]

S-1, which was incorporated on Date B under State C law, is currently engaged in the business of providing extended service contracts to the purchasers of new and used A products in State D, State E and State F and retains all of the risks that it assumed in these states.[2] S-1 may, in the future, do business in additional states and may obtain indemnification from S-2 (or another insurer) with respect to that business as explained below.

S-1 was formed by Parent to act as obligor on both new A extended service contracts (contract x) and pre-owned A extended service contracts (contract y) on A products manufactured by Parent and other manufacturers. S-1's formation by Parent is to consolidate the extended service contract activities and provide greater management accountability. The (x and y) extended service contracts will hereinafter be referred to as "the Contracts." All of the stock of S-1 is wholly owned by Parent.

S-2, which was incorporated on Date G under State D law, is a licensed property and casualty insurance company that provides dealerships selling Parent and non-Parent As with an array of specialty coverages. All of the stock of S-2 is indirectly owned by Parent.

S-1 and S-2 are members of Parent's consolidated group and file a consolidated return with Parent.

In general, the Contracts are bought by A purchasers for the purpose of supplementing factory warranties. The vast majority of the Contracts are sold to A purchasers at a negotiated price through the same dealers which sell the A products. The dealers remit a given amount to S-1 and the dealer retains the balance of the sales proceeds on the Contracts. The Contracts cover

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[1] Some dealers (currently less than 1 percent) are Parent "owned" through its minority dealer program.

[2] The vast majority (greater than 95 percent) of the extended service contracts are sold through Parent's independent dealer network. The remainder will be sold by S-2 through direct solicitation.

specific costs of certain mechanical breakdowns that are caused by the failure of covered parts in normal use and are not covered under the A product factory warranty. Under the contracts, S-1 is obligated to the owner (or in certain cases the lessee) of any covered vehicle to pay for the cost of labor and parts required for the covered repairs. These repairs are usually performed by authorized franchised Parent dealers.[3] Neither Parent nor S-1 will perform any repairs.

The Contract protects the product A purchaser or lessee against the economic risk of mechanical breakdown or other failure of covered parts not covered under the applicable factory warranty. Like the new factory warranty, the Contract provides coverage for a period of time or number of usage units, whichever comes first.[4]

In the states where S-1 is currently doing business, it has not been required nor has it elected to obtain indemnification from a licensed carrier for the risks it has assumed. However, state law and administrative practices regarding the sale of extended service contracts vary significantly. Many states require that the obligor on an extended service contract purchase indemnity insurance (e.g., reimbursement insurance) from a licensed carrier. In lieu thereof, some states may allow S-1 to obtain surety insurance from a licensed carrier. Such insurance is designed to protect the consumer from the insolvency or other default of the contract obligor. Under such arrangements, the contract obligor remains liable to the customer, but the contract obligor is indemnified by the licensed carrier. In this connection, S-1 may from time to time enter into insurance arrangements with insurance companies such as S-2 which are owned in whole or in part by Parent. Under these indemnification

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[3] Under some circumstances repairs may be performed by others unrelated to Parent or its dealers.

[4] For example, a new A product may be sold with a new factory warranty covering the A for 3 years or r usage units whichever comes first. By way of further example, the Contract purchased on the same A may provide protection for 7 years or s usage units whichever comes first. If the product suffers a covered failure in normal use during the first 3 years of ownership and before r usage units has occurred the A will be repaired under the terms of the new product factory warranty. This will be true even if the same failure is also covered under the Contract. If, however, the new product factory warranty has expired (i.e., either more than 3 years have passed or the A product has exceeded r usage units) and the failure is for a covered repair, the Contract will apply if the time or usage unit limits for the Contract have not been reached.

agreements, S-1 would be reimbursed for the portion of its policy risks under the Contracts by S-2, another affiliate or an unrelated insurer.

S-1 acts as the obligor on the Contract and as such is directly liable to the purchaser of the Contract. S-1 is neither the manufacturer nor the seller of the covered A product. Parent continues to research the state laws and administrative procedures regarding the conduct of S-1’s business. By way of explanation, some states may treat S-1 as a "third party obligor" and may require S-1 as such to purchase insurance to protect consumers from any possible default by S-1. It is possible that other states may permit S-1 to retain the entire extended service contract risk on such contracts sold in the state. Where S-1 purchases insurance of some type, it will in all likelihood be purchased from an affiliate of Parent such as S-2. However, S-1 may choose to substitute another licensed insurance company for S-2 and, generally, may do so without cancelling and reissuing the Contracts.

Parent represents as follows:

(1) Where permitted by state law, S-1 will be the issuer and the named obligor on the Contracts and will be directly liable to the Contractholder under the terms of the Contract.

(2) S-1 will issue the vast majority of the Contracts through the Parent’s independent dealer network.

(3) S-1 will not be the obligor on any of Parent’s new product factory warranties.

(4) In the states in which S-1 issues policies, it does not intend to be a licensed insurer.

(5) None of the policies issued by S-1 will cover the payment of costs for which Parent is liable under the manufacturer’s warranty.

(6) Other than a dealer who might own an insignificant percentage of Parent’s publicly traded stock, none of the stock of S-1 will be owned, directly or indirectly, by any dealer.

> (7) The contracts will pass insurance risk and are not merely financing arrangements. Similarly, any insurance (or reinsurance) arrangement entered into by S-1 with S-2 or another insurer will also pass risk and will not be merely a financing arrangement.

Insurance companies other than life insurance companies are taxed under § 831. Section 1.831-3(a) of the regulations states that for purposes of §§ 831 and 832, the term "insurance companies" means only those companies which qualify as insurance companies under former § 1.801-1(b) of the regulations (now § 1.801-3(a)(1) of the regulations).

Section 1.801-3(a)(1) of the regulations states 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.

Whether an entity is an insurance company for federal income tax purposes depends upon the character of the business actually done in the taxable year. If an entity is primarily engaged in the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies, then the entity is subject to tax as an insurance company regardless of its classification under state law. Sections 1.831-3 and 1.801-3(a)(1) of the regulations; Rev. Rul. 83-172, 1983-2 C.B. 106; Rev. Rul. 71-404, 1971-2 C.B. 260. <u>See also</u> <u>Bowers v. Lawyers Mortgage Co.</u>, 285 U.S. 182, 188 (1932); <u>Commissioner v. W. H. Luguire Burial Ass'n Co., Inc.</u>, 102 F.2d 89, 90 (5th Cir. 1939).

Neither the Internal Revenue Code nor the regulations thereunder define the terms "insurance" or "insurance contract." The accepted definition of "insurance" for federal tax purposes relates back to <u>Helvering v. LeGierse</u>, 312 U.S. 531 (1941), in which the Supreme Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." <u>Id.</u> at 539. Case law has defined an insurance contract as "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." <u>Epmeier v. United States</u>, 199 F.2d 508, 509-510 (7th Cir. 1952). In addition, the risk transferred must be a risk of economic loss. <u>See</u> <u>Allied Fidelity Corp. v. Commissioner</u>, 66 T.C. 1068 (1976), <u>aff'd</u>, 572 F.2d 1190 (7th Cir. 1978), <u>cert. denied</u>, 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 loss to the insurer. 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 proceeds of an insurance payment. See Rev. Rul. 88-72, 1988-2 C.B. 31, clarified by Rev. Rul. 89-61, 1989-1 C.B. 75. Cf. Rev. Rul. 92-93, 1992-2 C.B. 45 (permitting parent company to deduct the premiums paid to the insurance subsidiary for the group-term life insurance on an employee of the parent).

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). 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. 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). That is, when the sample number increases, the probability density function of the average loss tends to be more concentrated around the mean. Due to this increase in predictability, there is a downward trend in the amount of capital that a company needs per risk unit to remain at a given level of solvency. See Rev. Rul. 89-61, supra.

Rev. Rul. 77-453, 1977-2 C.B. 236, concludes that, for a casualty insurance company, reinsurance premiums are deductible from gross premiums written in calculating premiums earned under § 832(b)(4).

Section 832(b)(4) provides that the term "premiums earned" on insurance contracts during the taxable year includes the amount of gross premiums written on insurance contracts during the taxable year less return premiums and premiums paid for reinsurance and 20 percent of the increase in unearned premiums.

Based upon the description of the Contracts provided, we conclude that, for purposes of the rulings requested, the Contracts are insurance contracts and not prepaid service contracts. Unlike prepaid service contracts, the A service contracts are aleatory contracts under which S-1, for a fixed price, is obligated to indemnify a contractholder for the economic loss arising from the mechanical failure of a system or part during the contract period. Because S-1 does not provide any repair services, the Contracts are not prepaid service contracts. Further, by accepting a large number of risks, S-1 distributes the risk of loss under the Contracts so as to make the average loss more predictable. Thus, the Contracts have the earmarks of insurance as it has commonly been conceived in proper understanding and usage.

As indicated, S-1 and S-2 are brother-sister companies in Parent’s affiliated group. It is the Service’s position that the risk shifting prerequisite to a contract of insurance cannot exist when a corporation purports to purchase insurance within the same "economic family" as the insured. Rev. Rul. 77-316, 1977-2 C.B. 53. If, however, the insureds are not economically related to the corporation, then there is risk shifting and risk distribution. See Rev. Rul. 92-93, supra, (the parent’s employees were viewed as insureds unrelated by stock ownership to either the parent or its insurance subsidiary). In the present case, S-1 has assumed the risk of loss incurred by the third party policyholders, and not the members of its own economic family. Accordingly, risk shifting exists in the transaction.

Based upon the facts and representations as stated above, it is held that:

> (1) S-1 will be an insurance company within the meaning of §§ 831 and 832 of the Code and regulations thereunder so long as its primary and predominant business is issuing the Contracts.
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> (2) S-1 will be entitled to deduct under § 832(b)(4) premiums paid to S-2 (or another insurer) pursuant to an agreement whereby S-2 (or another insurer) has indemnified S-1 for insurance risks associated with the Contracts.

No opinion is expressed as to the tax treatment of the transaction under the provisions of any other section of the Code and regulations which may also be applicable, or to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction which are not specifically covered by the above holdings. Specifically, no opinion has been requested and no opinion is expressed as to the tax treatment by S-1 of the amounts described as "commissions" to compensate the dealers for selling the Contracts, or to the treatment by S-2 of any reimbursement for any expense it incurred in originally entering into the transaction with the dealers. No opinion is expressed concerning the treatment of amounts paid by S-1 to S-2 (or an unrelated insurer) to the extent those amounts properly relate to credit risks (of S-1's insolvency) rather than insurance risks of S-1. Further, no opinion is expressed concerning the application of § 845 to the transaction.

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.

A copy of this letter should be attached to the next consolidated federal income tax return to be filed by Parent.

Sincerely yours,

Assistant Chief
Counsel (Financial
Institutions
and Products)

By:______________________
Mark S. Smith
Chief, Branch 4

cc to: