Internal Revenue Service

Number: **200340011**
Release Date: 10/3/2003
Index Number: 831.03-00, 832.00-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:BO4 - PLR-113056-03
Date:
July 01, 2003

Legend

Parent:

Taxpayer:
State A:
IC:
Administrator:

Dear :

This is in response to your authorized representative's submission dated February 19, 2003, requesting rulings that (1) certain extended service contracts issued by Taxpayer are insurance contracts for Federal income tax purposes, and (2) that Taxpayer will qualify as an insurance company taxable under section 831 of the Internal Revenue Code.

FACTS

Parent is a corporation organized under the laws of State A and is engaged in business as a franchised automobile dealership. Parent has elected, pursuant to the check the box Income Tax Regulations, to be treated as an association taxable as a C corporation for federal income tax purposes. Parent files its federal income tax returns on a calendar year basis and employs the cash receipts and disbursement method of accounting.

Parent sells only one make of new automobiles but sells all makes and models of used automobiles. As a franchised dealership, Parent also maintains a large parts department, service department, and body shop. In connection with the sale of new and used automobiles, Parent has offered its customers extended service contracts. To date, the extended service contracts offered by Parent are written in the standard form of dealer obligor contracts. In general, Parent's customers purchase the extended service contracts for the purpose of supplementing the manufacturer's warranty on the vehicle. Under the extended service contracts, Parent agrees to assume the costs of automobile breakdowns if the mechanical breakdowns are caused by the failure of a covered part in normal use and if that covered part is not already covered under a manufacturer's warranty. While Parent would prefer that the extended service contract holders take advantage of its service department, the contract holders do not need to have their vehicle serviced by Parent in order to be reimbursed pursuant to the extended service contract.

Parent's current program of extended service contracts is administered by Administrator, an unrelated corporation. Administrator administers warranty products related to auto vehicle service agreements, recreational vehicle service agreements, auto reinsurance programs, self-funded programs, after market products, and manufacturer warranties. The services performed by Administrator include warranty administration services, claims administration, and adjusting functions. Administrator performs these services in exchange for an administrative fee paid by Parent.

As part of Parent's current program of extended service contracts, Parent has entered into an indemnification arrangement with IC, a licensed property and liability insurer which is unrelated to Parent. The indemnification arrangement is designed to protect the contract holder from the insolvency, or similar default, of Parent. Under the arrangement, Parent is required to deposit certain assets with IC equal to the required reserves and liabilities relating to the extended service contracts. In turn, IC agrees to hold these assets, together with investment income, in a custodial account on behalf of Parent. From the custodial account, IC makes withdrawals to cover Parent's share of premiums refunded as a result of cancellation of individual coverages, Parent's share of claims with respect to the extended service contracts, Parent's share of investment income and underwriting profits in excess of required reserves, and IC's own investment and custodial expenses. IC becomes liable to contract holders under Parent's extended service contracts only if Parent defaults. However, IC's liability to contract holders is limited to the assets deposited by Parent in the custodial account plus credited investment earnings, less prior withdrawals from such account.

Under the proposed transaction, Taxpayer will be formed as a separate corporation under the laws of State A, with the same ownership as Parent, for the purpose of issuing extended service contracts. Taxpayer will be the sole obligor for all extended service contracts that it issues. The extended service contracts issued by Taxpayer will continued to be marketed by Parent to purchasers of new and used cars, and will provide contract holders with the same level of coverage with respect to the costs of mechanical breakdowns as Parent's current dealer obligor extended service contracts. Under the marketing arrangement, Parent will sell the extended service contracts at a price to be negotiated by Parent and the vehicle customer. After collecting the contract sales price, Parent will remit a pre-determined amount to Taxpayer to cover reserve requirements and administrative fees. The balance of the contract sales price will be retained by Parent as compensation for the sale of the extended service contracts.

As the obligor under the extended service contracts, Taxpayer will be obligated to the contract holder to pay for the cost of labor, parts, and necessary repairs caused by mechanical breakdown if the mechanical breakdowns are caused by the failure of a covered part in normal use and if the covered part is not already covered under the manufacturer's warranty. Taxpayer will provide no automotive repair services to the holders of the extended service contracts. While the terms of the extended service contracts provide incentives for the contract holder to return the vehicle to Parent for covered repairs, the contract holder can choose the service facility. However, if the contract holder chooses a facility other than Parent, the contract holder must have the problem diagnosed and approved by Administrator prior to the start of any work.

Under the laws of State A, Taxpayer will not be treated or recognized as an insurance company. However, Taxpayer may be required to obtain indemnification from a licensed insurance carrier for the risks that Taxpayer has assumed under the extended service contracts. If so required, it is anticipated that Taxpayer will enter into an indemnification arrangement with IC similar to that currently used in Parent's extended service contract program. Accordingly, Taxpayer will deposit assets with IC equal to the required reserves for the extended service contracts, and IC will maintain those assets, together with investment earnings, in a custodial account for IC subject to the withdrawal provisions described above. Taxpayer will be primarily liable to holders of the extended service contracts, and IC will only become liable to the contract holders if Taxpayer defaults. However, IC's liability to contract holders is limited to the assets deposited by Taxpayer in the custodial account plus credited investment earnings, less prior withdrawals from such account.

Taxpayer anticipates accepting a large number of risks. The number of risks is dependent on the number of extended service contracts sold. Accepting a large number of risks will enable Taxpayer to use the law of large numbers so as to make its average loss statistically more predictable.

LAW AND ANALYSIS

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

Section 1.801-3(a) of the Income Tax Regulations provides that, for purposes of sections 831 and 832, the term "insurance companies" means only those companies that qualify as insurance companies under the definition of former section 1.801-1(b) (now section 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 predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwriter 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 C.B. 107 (holding taxpayer was an "insurance company," as defined in section 1.801-3(a)(1), notwithstanding that taxpayer was not recognized as an insurance company for state tax purposes.

To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Indus. Life Ins. Co. v. United States, 344 F. Supp. 870, 877 (D.S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973), cert. denied, 414 U.S. 1143 (1974). To determine whether a taxpayer qualifies as an insurance company, all of the relevant facts will be considered, including but not limited to, the size and activities of its staff, whether it engages in other trades or businesses, and its sources of income. See generally, Bowers, 285 U.S. 182; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92 (N.D. Tex. 1969), rev'd on other grounds, 293 F.2d 72 (8th Cir. 1961); Inter-Am. Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1971); Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933), Notice 2003-34, 2003-23 I.R.B. [INSERT PAGE], status of an offshore insurance company investing in hedge funds.

Neither the Internal Revenue Code nor the regulations thereunder, define the terms "insurance" or "insurance contracts." The accepted definition of "insurance" for federal income tax purposes relates back to Helvering v. LeGierse, 312 U.S. 531, 539 (1941), in which the Supreme Court stated that "historically and commonly insurance involves risk-shifting and risk distributing." Case law has defined "insurance" as involve[ing] a contract, whereby, for adequate consideration, one party agrees to indemnify another against loss arising from certain specified contingencies or perils…. [I]t is contractual security against possible anticipated loss." See Epmeir 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 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, 2001-1 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. 811 F. 2d at 1300.

Based on the information submitted, we conclude that, for federal income tax purposes, the extended service contracts to be issued by Taxpayer are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the extended service contracts are aleatory contracts, under which Taxpayer, for a fixed price, is obligated to indemnify the contract holder for economic loss, not covered by the manufacturer's warranty, arising from the breakdown of, and repair expense to, a purchased automobile from damage to tire from road hazards. The contracts are not prepaid service contracts because Taxpayer does not provide any repair services. Further, by accepting a large number of risks, Taxpayer will distribute the risk of loss under the contracts so as to make the average loss more predictable.

Based on Taxpayer's representations concerning its proposed business activities, we find Taxpayer's "primary and predominant business activity" will be the issuing of extended service contracts, which we have just concluded are insurance contacts for federal tax purposes. Thus, under section 1.801-3(a)(1) of the Regulations, Taxpayer will qualify as an "insurance company" for purposes of section 831 of the Code.

CONCLUSIONS

The extended service contracts to be issued by Taxpayer are insurance contracts for federal income tax purposes. Taxpayer also will qualify as an "insurance company" for purposes of section 831 of the Code.

CAVEAT

Except as expressly provided herein, no opinion is expresses or implied concerning the consequences of any aspect of any transaction or item discussed or referenced in this letter.

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 extended warranty contracts pay to Parent for their contracts.

No ruling has been requested, and no opinion has been expressed, concerning what amount, if any, paid by the purchasers of the extended service contracts and retained by Parent is deductible as a commission expense by Taxpayer.

No ruling has been requested, and no opinion has been expressed, concerning the reinsurance arrangement. It should be noted that certain reinsurance arrangement as described in Notice 2002-70, 2002-44 I.R.B. 765, are identified as "listed transactions" for purposes of section 1.6011-4T(b)(2) of the temporary Income Tax Regulations and section 301.6111-2T(b)(2) of the temporary Procedure and Administration Regulations.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to 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 the taxpayer and accompanied by a penalty of perjury statement executed by the 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 yours,
GARY E. GEISLER
Assistant to Branch Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions and Products)

cc: