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Telephone Number:

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Legend

Parent	=
Company 1	=
Company 2	=
Product	=
State 1	=
A	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
I	=
J	=
K	=

L =

M =

N =

O =

P =

Q =

R =

S =

T =

U =

V =

W =

X =

Dear

This responds to the letter dated November 18, 1999 (and to the supplemental letters) submitted to the Internal Revenue Service on behalf of Parent by its representative. That November 18th letter requested rulings that Company 1 and Company 2 (hereinafter, sometimes, the Companies) both of which are members of the affiliated group of which Parent is the parent company, (1) will be treated, with respect to the Product service contracts they sell, as issuing insurance contracts for federal income tax purposes; (2) will be treated as insurance companies for federal income tax purposes; and, (3) are entitled to deduct currently, premiums paid to affiliated insurance companies in connection with the transactions described below. The supplemental letters provided additional information to the Internal Revenue Service in connection with that request.

Parent is a publicly traded State 1 corporation and the parent company of an affiliated group that includes the Companies, several licensed insurance companies, and a holding company owning the stock of several license insurance companies. Parent's principal business activity is the manufacture and sale of Products. Parent sells its Products primarily through a network of independently owned and operated A's.

A's frequently make available to retail buyers the opportunity to purchase

Product service contracts for protection against mechanical breakdown or failure of certain covered parts. These contracts are purchased by retail Product purchasers for the purpose of supplementing the manufacturer's base factory warranties. They extend mechanical breakdown protection to the retail buyer beyond the manufacturer's base warranty in terms of time, B, and repair coverage.

Parent historically has offered Product service contract programs for C's to sell to retail Product purchasers.[1] These Product service contracts have been offered under the brand names D, E, and F . The D program covers new and used Product manufactured by Parent, except for G Products which are covered by the E. F contracts are contracts purchased by retail purchasers of new and used Products manufactured by a competitor.

Because of the various state regulatory requirements, Parent's Product service contracts are structured in various forms. These include: (1) D service contracts under which Parent is the obligor; (2) E service contracts under which G is the obligor; (3) F service contracts under which a Parent affiliate is the obligor; and, (4) F service contracts under which the C is the obligor. Although variations to these basic programs exist, all the plans essentially fall into one of these categories.

The plans have various levels of coverage depending on the coverage level desired by the retail customer. For example, the H contract covers the I and related failures. The J covers the H and other major components of the Product (i.e., I, K, L, M, and N, and certain O items), and the P contract covers almost all parts of the Product. All plans include Q and most include R coverage, within certain limits.

If a covered part needs to be repaired, the customer may have it repaired at any participating C or repair facility. Pursuant to an arrangement with the C or facility, the obligor of the particular plan agrees to reimburse the C or other repair facility for repairs performed to a retail customer's Product under any of the Parent Product service contracts. C participation in the D, E, and F programs is entirely voluntary. In connection with its arrangement with parent, the C retains an amount generally equivalent to the difference between the selling price to the retail customer and the cost amount charged to the C by the contract issuer.

In response to the changing regulatory environment and competitive market,[2] and to consolidate the management of and accounting and billing for the mechanical

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1 Parent Product service contracts are also sold through direct mail campaigns.

2 The National Association of Insurance Commissioners developed a Model Act with respect to extended warranty service contracts. Under the Act, third-party obligors may issue service contracts and these contracts are not state regulated specifically as "insurance" products. Adoption of the Model Act by states thus allows third-party obligors to issue contracts in the state without regulation as actual insurance companies.

breakdown Product service contract business, Parent recently created Companies 1 and 2 to transact the Product service contract business as third-party obligors in those states which permit third-party obligor arrangements and do not regulate the Product service contracts as insurance.

Parent indicates that it is structuring the transactions in order to separate its Product service contract business, which is a financial service business, from its manufacturing and other operations. It indicates that by moving its Product service contract business into separate corporations, accounting for the revenues and expenses of that business will be simplified and Parent will be better able to focus certain risks and responsibilities associated with that business. For example, the transactions should serve to shift and isolate liabilities under the Product service contracts in Companies 1 and 2.

Further, laws in certain states allow the Product service contract business to be carried on in entities such as Companies 1 and 2, whose products are regulated as service contracts, and not as insurance. Parent seeks to take advantage of these laws. Parent does not wish to place the Product service contract business in its existing insurance company subsidiaries because that business would then be considered mechanical breakdown insurance that would be subject to additional regulation. Under such regulation an individual state could regulate the rates charged and the forms to be used in that state. The additional regulation also could require the licensing of adjusters and agents which would substantially impact the ability to compete in the marketplace with other companies selling Product service contracts. Companies such as Companies 1 and 2 are not subject to such stringent requirements.

Under a third-party obligor arrangement, third parties that are neither the manufacturer nor seller of Products issue and sell the Product service contracts. Thus, Companies 1 and 2 will not be the manufacturer, supplier, or seller of the Products and will not make any repairs, but will merely promise to indemnify the customer for any insured loss (e.g., repair and other related expenses) that the customer suffered as a result of the breakdown or failure of mechanical parts covered by the Product service contract.

Companies 1 and 2 will issue and sell D, E and F service contracts[3] to retail customers through the Parent A network in the same manner that the current Product service contracts are sold.[4] Accordingly, the Cs will retain an amount generally equivalent to the difference between the selling price to the retail customer and the C cost amount charged to the C by Company 1 or 2. The contract entered into between Company 1 and Company 2, and the retail customer, will provide the customer with

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[3] The form of the contracts issued by Companies 1 and 2 will be the same as the contracts currently issued under the D, E, and F programs, except that Companies 1 and 2 will be the administrators and the only obligors.

[4] Companies 1 and 2 will not issue contracts that are sold through direct mail.

protection on the identical to the protection offered under the current D, E, and F Product service contracts. Thus, the customer may continue to have the repaired at any participating C or repair facility and Company 1 or Company 2 would be obligated to reimburse such facility on behalf of the customer for any repairs performed on a covered part.

In part to comply with certain state law requirements, Companies 1 and 2 will purchase an indemnification insurance agreement from a licensed property and casualty insurance company.[5] Under the indemnification agreement, the insurers will indemnify Companies 1 and 2 for 100% of the losses on repairs made pursuant to the Product service contracts. Companies 1 and 2, however, will in all cases remain directly liable to the retail buyers of the Product service contracts.

Companies 1 and 2 will retain administrative responsibility for the contracts they issue. For each contract they issue they will pay an amount to Parent or a Parent subsidiary for the use of the relevant company's billing systems and for that relevant company's role in collecting the premiums due for the Product service contracts. In addition, for each Product service contract issued, Company 1 or Company 2 will incur administrative expenses and certain expenses attributable to the Cs.

Companies 1 and 2 will be party to an intercompany services and facilities contract with V under which V will agree to furnish personnel, supplies, equipment, services and facilities needed by Companies 1 and 2. In accordance with Regulation of the Insurance department, Companies 1 and 2 will be charged cost for any personnel, services, etc. that they receive in accordance with the intercompany agreement. It is expected that Companies 1 and 2 will utilize the intercompany agreement to obtain the services of T's processing center for processing new business and payment of claims, of V's actuarial department for pricing the Product service contracts, of W's marketing department for marketing the Product service contracts, and of other T personnel for developing contracts, ensuring regulatory compliance and other miscellaneous activities.

For tax purposes, Company 1 and 2 will include the full amount of the contract consideration paid by the customers in written premiums and will claim deductions for the unearned portions of those amounts, as well as for the amounts retained by the Cs . Both Company 1 and Company 2 companies will reduce their written premiums by amounts paid to S and U for reinsurance.

Companies 1 and 2 were initially organized with capital of $100,000. The Board of V, a member of the Parent affiliated group, has specifically authorized further capital

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[5] Company 1 will purchase an insurance indemnification agreement from S, a licensed insurance company that is a wholly owned subsidiary of T, which is a member of the Parent affiliated group. Company 2 will purchase a similar insurance indemnification agreement from U, another licensed insurance company that is wholly owned by T.

up to X for each company as necessary to implement each of their business plans.

With respect to the transactions described herein, Parent represents the following: (a) none of the Product service contracts issued by Companies 1 and 2 will cover the payment of costs for which Parent is liable under the base manufacturer's warranty; (b) Parent will own 100% of Companies 1 and 2 through one or more members of the Parent affiliated group; (c) other than a C who might own an insignificant percentage of Parent's publicly traded stock, none of the stock of Company 1 or Company 2 will be owned, directly or indirectly, by any C; and, (d) substantially all of the business of each of Companies 1 and 2 will consist of entering into Product service contracts, administering those contracts, obtaining reinsurance for its liabilities under those contracts, and investing an amount of capital that is necessary and appropriate to support its liabilities under those contracts.

Applicable Law and Rationale

Whether an entity is an insurance company for federal income tax purposes depends on the character of the business it actually does in the taxable year. Section 1.831-3(a) of the regulations states that for purposes of §§ 831 and 832, the term "insurance company" means only those companies qualifying as insurance companies under former § 1.801-1(b) (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.

Section 832(b)(4) provides, in part, that the term "premiums earned" means an amount computed by deducting premiums paid for reinsurance from the amount of gross premiums written on insurance contracts during the taxable year.

Whether an entity is an insurance company for federal income tax purposes depends on the character of the business it actually does 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. See also, Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932); Commissioner v. W. H. Luguire Burial Ass'n Co., Inc., 102 F.2d 89, 90 (5^{th} 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 income tax purposes relates back to Helvering v. LeGierse, 312 U.S. 531 (1941) in which the Supreme Court stated that, "[h]istorically and commonly insurance involves risk shifting and risk distributing". Id. 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”. 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, 66 T.C. 1068 (1976), aff’d, 572 F.2d 1190 (7th Cir. 1978), 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 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 insurance proceeds. See Rev. Rul. 92-93, 1992-2 C.B. 45 (permitting a parent company to deduct the premiums paid to the insurance subsidiary for 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 a company needs per risk unit to remain at a given level of solvency. See Rev. Rul. 89-61, 1989-1 C.B. 75.

Based on the description of the Product service contracts, we conclude those contracts are insurance contracts and not prepaid service contracts. Unlike prepaid service contracts, the Product service contracts are aleatory contracts under which Company 1 or Company 2, for a fixed price, is obligated to indemnify a contractholder for the economic loss arising from the failure of a system or a part during the contract period. Because the obligor does not provide any repair services, the contracts are not prepaid service contracts. Further, by accepting a large number of risks, Companies 1 and 2 will distribute the risk of loss under the Product service contracts so as to make the average loss more predictable.

Based on the facts and representations as stated above, it is held that for federal income tax purposes:

(i) the Product service contracts issued by Companies 1 and 2 are insurance contracts;

(ii) Company 1 and Company 2 each will be an insurance company within the meaning of § 831 and the regulations thereunder so long as its primary and predominant business consists of entering into service contracts, administering those Product service contracts, and investing an amount of capital that is necessary and appropriate to support its liabilities under those contracts; and,

(iii) Company 1 and Company 2 will be entitled to deduct as current reinsurance premiums, the premiums paid to S and U for policies indemnifying them against loss with respect to benefits payable under the Product service contracts.

Parent states that Company 1 and Company 2 include in their gross premiums written the entire amount customers pay to the Cs in connection with their acquisition of the Product service contracts, and that Companies 1 and 2 treat as a commission expense, an amount equal to the amount the Cs retain. No ruling has been requested, and no opinion is expressed, regarding whether Company 1 and Company 2's gross premiums written include the entire amount the customers pay to the Cs in connection with their acquisition of the Product service contracts, or whether any amount is deductible as a commission expense.

Further, no opinion is expressed as to the tax treatment of the transactions discussed herein 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.

This ruling is directed only to the taxpayer requesting 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 Taxpayer's next tax federal income tax return.

Sincerely yours,
Assistant Chief Counsel
(Financial Institutions and Products)
By: Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4