INTERNAL REVENUE SERVICE

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June 20, 2001

Legend

Company =

Dealer =

State A =

Manufacturer M =

B =

C =

D =

Administrator =

Insurance Company R =

Dear

This responds to letters dated January 29 and April 24, 2001 in which Company requested certain rulings. The requested rulings are that: (1) the contracts under which Company provides coverage for motor vehicles against mechanical breakdown (beyond the coverage afforded by the manufacturer's warranties) qualify as insurance contracts, and (2) Company will be treated as an insurance company for federal income tax purposes in the year 2001.

FACTS

Company is incorporated in State A. Company is not recognized as an insurance company under the laws of State A. All of the stock of Company is owned by Dealer, which is engaged in business as an automobile dealership company and is also incorporated under the laws of State A. Dealer is owned by five related individuals.

Company's only business activity is the issuing of motor vehicle service contracts (MVSCs) in which it is the obligor. The MVSCs will be marketed by Dealer, which is a franchisee of Manufacturer M and is licensed to sell new B, C and D lines of motor vehicles.

The MVSC provides the purchaser with protection against economic loss for certain expenses related to mechanical breakdown and repair of the purchased motor vehicle that are not covered by the manufacturer's warranty. The MVSC also covers a portion of (i) towing costs, (ii) replacement rental costs, and (iii) emergency roadside service labor, associated with a mechanical breakdown. The MVSC does not cover any preventative or routine maintenance (e.g., oil or other fluid changes or engine tune ups) or similar services. It also does not cover incidental or consequential damages, such as property damage, personal injury, inconvenience, or loss of automobile use.

The terms of the MVSC provide that Company agrees to pay for the repair or replacement of any covered parts that are defective in materials or workmanship, except for the deductible for the contract period. The contract period, which varies based upon the coverage selected, is based upon a maximum period of time or a maximum number of miles driven, whichever occurs first. As indicated above, the terms of the MVSC do not cover parts that are covered by a manufacturer's warranty. Therefore, except for the coverage of certain towing and rental replacement costs, or those MVSCs that cover parts that are not covered by a manufacturer's warranty, liability under the MVSC does not arise until the manufacturer's warranty expires. Further, Company represents that none of the MVSCs issued by Company will cover payment for costs for which either the manufacturer or Dealer would be liable under warranties associated with the vehicle or other products sold.

When Dealer sells an automobile, Dealer offers the purchaser of the vehicle a MVSC to supplement the manufacturer's warranty. Dealer is authorized to complete the form provided by Company and to collect the premium from the purchasers of the MVSCs. For each MVSC sold, Dealer remits a specific portion of the premium to Company and retains the balance as a "commission."[1]

Company does not provide repair services to the holders of MVSCs. Company merely reimburses the repairing facility, or the holder of the MVSC, for costs of automotive repairs covered under the agreement. The MVSC allows the contractholder to choose the repair facility. Under the MVSC, the purchaser must then have a problem diagnosed and report an estimate of the cost of repairs to Administrator for approval prior to starting any work.

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[1] The MVSCs are administered for Company by Administrator. Administrator is unrelated to Company and Dealer. Administrator is responsible for preparing weekly claims paid and claims pending reports and investigating and processing all claims presented under the MVSC program. Notwithstanding these contracts with Administrator, Company is the obligor on the MVSC and is liable to the contractholders of the MVSCs.

In the event that a contractholder cancels coverage under the MVSC prior to its expiration date, Company would make a refund to the contractholder of the unexpired portion of the MVSC premium pursuant to a formula set forth in the MVSC.

Company has entered into a (reinsurance) agreement with Insurance Company R, an unrelated insurance company, who agreed to indemnify Company for excess losses on mechanical breakdown occurrences pursuant to the MVSCs. More specifically, Company initially takes all of the risk on the MVSCs that are written. Company then reinsurers with Insurance Company R risk over $400 per contract written during each 12-month period on an aggregate stop loss basis.

Over the next four years, Company plans to undertake an increasing amount of MVSC business that Dealer is expected to produce for it, including, at a future time, extended "warranty" (mechanical breakdown) contracts on used motor vehicles, thus, increasing the number of risk exposures to which Company is subject. Other than Dealer allowing Company to incrementally write a greater portion of the extended "warranty" business that it can produce, there are no written or unwritten agreements, understandings, etc. between Dealer and its shareholders with respect to Company's operations.

LAW AND ANALYSIS

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

Insurance companies subject to tax under § 831 of the Code are required to determine gross income under § 832(b)(1). Section 832(b)(1)(A) provides that one of the items taken into account is the combined gross amount earned during the taxable year from investment income and from underwriting income computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. Section 832(b)(3) defines "underwriting income" as premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. Section 832(b)(4) provides that "premiums earned on insurance contracts during the taxable year" is the amount generally computed as follows: (1) from the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance; and (2) to the amount determine in (1) add 80% of the unearned premiums on outstanding business at the end of the preceding taxable year and deduct 80% of the unearned premiums on outstanding business at the end of the taxable year.

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 that the taxpayer was an “insurance company,” as defined in § 1.801-3(a)(1), notwithstanding that the taxpayer was not recognized as an insurance company for state law purposes).

Neither the Code nor the regulations 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 a 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 (7^{th} Cir. 1952). In addition, the risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7^{th} 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, as modified by Rev. Rul. 2001-31, 2001-26 I.R.B. 1348 (while parent corporation purchased a group-term life insurance from its wholly owned insurance subsidiary, this did not cause the arrangement to be “self-insurance” because the economic risk of loss was not that of parent). 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 (9^{th} 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 smoothes out losses to match more closely its receipt of premiums. See Cloughtery Packing Co., 811 F.2d at 1300.

Based on the information submitted, we conclude that, for federal income tax purposes, the MVSCs are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the MVSCs are aleatory contracts under which Company, for a fixed price, is obligated to indemnify the purchaser of the MVSC for economic loss not covered by warranties provided by a manufacturer or a retailer, arising from the mechanical breakdown of, and repair expense to, a purchased motor vehicle. Thus, the MVSCs are not prepaid service contracts because Company's liability is limited to indemnifying the MVSC contractholder for losses in the event a mechanical breakdown occurs. Company does not provide any repair services itself and does not provide reimbursement for any preventative maintenance services provided by another entity nor is it providing for any reimbursement for any obligations that are properly the obligations either of Dealer or Manufacturer M. Further, by accepting a large number of risks, Company has distributed the risk of loss under the qualifying vehicle protection contracts so as to make the average loss more predictable.

Based on Company's representations concerning its business activities in providing the MVSCs, we find Company's "primary and predominant business activity" during 2001 is the issuing of the MVSCs, which we conclude are insurance contracts for federal income tax purposes. Thus, under § 1.801-3(a)(1) of the regulations, Company qualifies as an "insurance company" for purposes of § 831 of the Code for 2001.

CONCLUSIONS

(1) For 2001, MVSCs issued by Company, as described above, are considered insurance contracts for federal tax purposes.

(2) In 2001, Company 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 Company's gross premiums written include the entire amount the purchasers of the vehicle protection 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 MVSCs, and retained by Dealer is deductible as a commission expense by Taxpayer.

The rulings contained in this letter are based upon information and representations submitted by Company. 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.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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