**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**
December 21, 2001

**OFFICE OF CHIEF COUNSEL**

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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR INDUSTRY DIRECTOR, FINANCIAL SERVICES & HEALTHCARE, LMSB

FROM: LON B. SMITH
Associate Chief Counsel (Financial Institutions and Products)
CC:FIP

SUBJECT:

This memorandum constitutes Chief Counsel Advice. In accordance with § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

A potential issue may arise in examining Taxpayer for the 2000 tax year.

In the attached change in accounting method, we granted Taxpayer permission to change its method of accounting from reporting as an ordinary corporation to reporting as an insurance company subject to tax under Part II of subchapter L. We previously concluded in 200119039 that this taxpayer is an insurance company, based of the nature of its contracts and business operations.

In the course of processing the change in accounting method, it came to our attention that the § 481(a) adjustment was computed based on Taxpayer having no unpaid losses as of the beginning of the year of change. (The adjustment was comprised solely of unearned premium reserves under § 832(b)(4) as Taxpayer represented that it did not have unpaid losses, only ordinary account payables.)

It strikes us as unusual that this taxpayer would have no reserve for unpaid losses; it is possible that some amounts Taxpayer is treating as accounts payable are in

fact subject to discounting under § 846. On the other hand, upon examination you might conclude there is no problem. We did not conduct an examination of this issue, and it is the subject of an explicit caveat in the attached change in accounting method.

It is not entirely clear that in Taxpayer's state of incorporation the insurance regulator would not require non-life insurance companies to report such payables on Schedule P of the National Association of Insurance Commissioners (NAIC) annual statement. See NAIC, Accounting Practices & Procedures Manual, SSAP 55-3, para 4 (2001). Required reporting on NAIC Schedule P would be an indicator that § 846 discounting would also be required.

Associate Chief Counsel
(Financial Institutions & Products)
By: /s/
Mark Smith
Chief, Branch 4

ATTACHMENT

Change in method of accounting letter

INTERNAL REVENUE SERVICE

UIL Nos. 446.20-02
832.00-00

CC:FIP:4/CAM-110640-01
October 19, 2001

Legend:

Taxpayer =

Parent =

Subsidiary =

Commercial IC =

State =

Dear

This is in reply to the Application for Change in Accounting Method (Form 3115) filed by Taxpayer under the provisions of Rev. Proc. 97-27, 1997-1 C.B. 680. Taxpayer represents that, on the date the Form 3115 was filed, it was not under examination, before an appeals office or a federal court with respect to any tax issue. Taxpayer requests permission to change its method of accounting from being taxed as an ordinary corporation to being taxed as a non-life insurance company under Part II of subchapter L beginning with the tax year ending In a ruling letter (PLR-119217-00) dated February 8, 2001, this office concluded that for the tax year, the qualifying contracts (i.e., the dealer obligor contracts in which Taxpayer has assumed and retained the insurance risks, Taxpayer obligor contracts on which it retains all of the insurance risks and Taxpayer obligor contracts in which Taxpayer has reinsured the risks over to Commercial IC) are considered insurance contracts for federal income tax purposes. It was also concluded, inter alia, that for the tax year, Taxpayer was taxable under § 831(a) as an insurance company other than a life insurance company.

Taxpayer, a State corporation, is principally engaged in the provision of motor vehicle protection plans. Taxpayer is not recognized as an insurance company under the laws of State. All of the stock of Taxpayer is owned by Parent, which is a holding company also incorporated

under the laws of State. Taxpayer owns all of the stock of Subsidiary, which is incorporated under the laws of State and provides computer related support. Taxpayer and Subsidiary are includible members in Parent's consolidated income tax return.

Automobile dealers unrelated to Taxpayer offer the purchasers of new and used vehicles the opportunity to purchase vehicle protection contracts under Taxpayer's program. The vehicle protection contracts are designed to provide the purchaser with coverage in the event of a mechanical breakdown not otherwise covered by the manufacturer or automobile dealer. Numerous plans are available to vehicle purchasers based upon the type of coverage desired, the length of coverage desired, and the year and mileage of the vehicle to be covered.

The vehicle protection plans in Taxpayer's program include both a "dealer obligor" plan and an "administrator or Taxpayer obligor" plan. The type of plan offered is determined based upon whether or not state law allows an automobile dealer to sell a Taxpayer (administrator) obligor plan. The primary difference between these two plans is the identity of the party the purchaser enters into the agreement with. Under a dealer obligor plan, the dealer is a party to the agreement with the purchaser and, technically, is the party that is responsible for reimbursing the purchaser. Under a Taxpayer obligor plan, Taxpayer is the party responsible for reimbursing the purchaser. When it is required by state law that a commercial insurance company be responsible for a dealer obligor contract, the contract is "insured" by Commercial IC, a stock non-life insurance company and independent third party. Similarly, when required by state law, Taxpayer reinsures its Taxpayer obligor responsibilities pursuant to its vehicle protection contracts with Commercial IC.

The varying state law requirements result in four categories of vehicle protection contracts: (1) dealer obligor contracts "insured" with Commercial IC,[1] (2) dealer obligor contracts in which Taxpayer assumes and retains the insurance risks, (3) Taxpayer obligor contracts on which Taxpayer retains all of the insurance risks, and (4) Taxpayer obligor contracts in which Taxpayer has shifted the insurance risks over to Commercial IC. The latter three categories of contracts collectively are referred to in this letter as the qualifying contracts. The receipts related to the qualifying contracts are approximately 75% of Taxpayer's vehicle protection contracts receipts and, in any event, receipts from these contracts are expected to remain significantly greater than 50% of total receipts from Taxpayer's vehicle protection contract program.

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[1] Although all of the insurance risks in this first category of dealer obligor contracts ultimately reside in Commercial IC, these contracts are still administered through Taxpayer's vehicle protection plan program. Due to a number of factors, inter alia, uncertainty as to the state law characterization of the various relationships, in our consideration of PLR-119217-00 we were unable to determine the precise nature of Taxpayer's role with respect to first category of dealer obligor contracts. Accordingly, the federal income tax treatment of income and expenses within this first category of contract (dealer obligor contracts where the risks ultimately reside in Commercial IC) is not subject to this request for a change in method of accounting.

The price of any particular plan is negotiated between the automobile dealer and the purchaser. Taxpayer does not set the price at which the plan is ultimately sold to the purchaser. Taxpayer establishes a fixed cost that it charges the automobile dealer for each plan. The automobile dealer retains any amount charged the purchaser in excess of this fixed cost. The fixed cost includes an amount allocable to "insure" the plan and an amount allocable to administer the plan.

Funds are remitted by the automobile dealer to Taxpayer in either the full amount for which the vehicle protection plan was sold to the purchaser or the fixed cost charged the automobile dealer by Taxpayer. In the event the automobile dealer remits the full amount paid by the purchaser, Taxpayer issues a check to the dealer for any amounts in excess of the dealer's fixed cost for the vehicle protection plans sold. The issuance of these checks to the dealer is not necessarily done on an as sold basis, but rather is done at some regular interval such as monthly.

The purchaser of one of Taxpayer's vehicle protection plans follows certain procedures in order to make a proper claim. For example, generally, the purchaser or representative of the repair facility contacts Taxpayer before any work is performed for authorization. Taxpayer makes a diagnosis and a determination of covered items, subject to the terms and conditions of the agreement. Taxpayer then issues an authorization number. Taxpayer represents that once it has provided an authorization number and approved the amount of the repairs it merely has an ordinary account payable and not an unpaid loss subject to § 832(b)(5)(A)(ii) and § 846, which requires the discounting of unpaid losses. After ensuring that the claim is complete, payment is made by Taxpayer to the agreement holder or the repair facility. Taxpayer does not, however, perform any of the repair services covered pursuant to these vehicle protection plans

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 (NAIC). 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 determined 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 832(b)(5) provides that the term "losses incurred" is generally computed as follows: (i) from losses paid during the taxable year, deduct salvage and reinsurance recovered

during the taxable year, (ii) to the result so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in § 846) outstanding at the end of the taxable year and deduct all unpaid losses on life insurance plus all discounted unpaid losses outstanding at the end of the preceding taxable year, and (iii) to the results so obtained, add estimated salvage and reinsurance recoverable as of the end of the preceding taxable year and deduct estimated salvage and reinsurance recoverables as of the end of the taxable year.

Section 832(c)(1) provides that in computing the taxable income of an insurance company subject to tax under § 831 there shall be allowed for all ordinary and necessary expenses incurred as provided in § 162.

The information submitted indicates that the adjustment required by § 481(a) of the Code as of the beginning of the year of change is $ and represents a decrease in insurance company taxable income.

It should be understood that the amount of the § 481(a) adjustment, as well as the method of computation, is subject to verification upon examination of Taxpayer's return.

Based upon the information submitted and the representations made, permission is hereby granted to Taxpayer to change its overall method of accounting from its present method to that required for non-life insurance companies under Part II of subchapter L (i.e., the method required under § 832 for insurance companies subject to tax under § 831(a)), for federal income tax purposes, provided that:

(1) Taxpayer effects the change in accounting method for the year ended December 31, 2000 (year of change);

(2) Taxpayer takes the § 481(a) adjustment into account as a decrease in taxable income ratably over a four-year period, beginning with the year of change;

(3) Taxpayer keeps its books and records for the year of change and for subsequent taxable years on the method of accounting granted in this letter. This condition is considered satisfied if Taxpayer reconciles the results obtained in keeping its books and records and the method used for federal income tax purposes and maintains sufficient records to support such reconciliation. (Further, as part of its workpapers for filing its federal income tax return (Form 1120-PC),

Taxpayer completes, consistent with current statutory accounting procedures, those portions of the annual statement prescribed by the NAIC for Property and Casualty Companies that are necessary as a starting point for making the determinations and computations required under Part II of subchapter L); and

(4) in the event Taxpayer ceases to be taxable as an insurance company at any time prior to the expiration of the four-year adjustment period, Taxpayer must

take into account the remaining balance of the § 481(a) adjustment in the last year that it was taxable as an insurance company.

The accounting method change in this letter relates solely to Taxpayer's overall change to Part II of subchapter L. The accounting method change granted in this letter is a letter ruling pursuant to § 601.204(c) of the statement of procedural rules. See also section 2.01 of Rev. Proc. 2001-1, 2001-1 I.R.B.1, 9 (or any successor). Taxpayer may ordinarily rely on this letter ruling subject to the conditions and limitations described in Rev. Proc. 97-27.

The district director or successor must apply this ruling in determining Taxpayer's liability unless the director recommends that the ruling be modified or revoked. The director will ascertain whether (1) the representations on which the ruling was based reflect an accurate statement of the material facts; (2) the amount of the § 481(a) adjustment was properly determined; (3) the change in method of accounting was implemented as proposed in accordance with the terms and conditions of the CONSENT AGREEMENT and Rev. Proc. 97-27; (4) there has been any change in the material facts on which the ruling was based during the period the method of accounting was used; and (5) there has been any change in the applicable law during the period the method of accounting was used. If the director recommends that the ruling (other than the § 481(a) adjustment) should be modified or revoked, the director will forward the material to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 2001-2, 2001-1 I.R.B. 79 (or any successor) will be followed. See section 11.01 of Rev. Proc. 97-27.

An examining agent may not propose that Taxpayer change to the same method of accounting as the method changed by Taxpayer under this ruling for a year prior to the year of change provided Taxpayer implements the change as proposed in accordance with the terms and conditions of this ruling and Rev. Proc. 97-27, and the ruling is not modified retroactively because there has been a misstatement or omission of material facts. See sections 9.02(4) of Rev. Proc. 97-27.

However, the Service may change Taxpayer's method of accounting for the same item for taxable years prior to the requested year of change if there is any pending or future criminal investigation or proceeding concerning (a) directly or indirectly, any issue relating to Taxpayer's federal tax liability for any taxable year prior to the year of change, or (b) the possibility of false or fraudulent statements made by Taxpayer with respect to any issue relating to its federal tax liability for any taxable year prior to the year of change. See section 9.02(4) of Rev. Proc. 97-27.

If Parent agrees to the terms and conditions reflected above, an individual with authority to bind Parent in such matters must sign and date the attached copy (CONSENT AGREEMENT) and return it to the Commissioner of Internal Revenue, Attn: CC:FIP:4, Room 4107, 1111 Constitution Avenue, N.W., Washington, D.C. 20024, within 45 calendar days from the date of this letter. The signed copy (CONSENT AGREEMENT) constitutes an agreement within the meaning of § 481(c) of the Code and § 1.481-4(b) of the regulations, and shall be binding on both parties except that it will not be binding on the Service upon a showing of fraud,

malfeasance, or misrepresentation of a material fact upon which Taxpayer based its request. In addition, a copy of the executed CONSENT AGREEMENT must be attached to the Parent's consolidated income tax return for the year of change. For further instructions, see section 8.11 of Rev. Proc. 97-27. If the signed CONSENT AGREEMENT is not returned within 45 days, the letter granting permission for the change in accounting method will be null and void.

Caveats

We express no opinion whether unpaid amounts (and any related expenses) characterized by Taxpayer as ordinary accounts payable are instead unpaid losses (under § 832(b)(5)(A)(ii)) subject to the required discounting of § 846. Further, this letter is directed only to Taxpayer and 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 yours,
MARK SMITH
Chief, Branch 4
Office of Associate
Chief Counsel
(Financial Institutions & Products)

Signed this _____
day of _____, 2001

_____
(Taxpayer)

By: _____

_____
(Title)

cc