INTERNAL REVENUE SERVICE

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June 5, 2002

Company =

Year 1 =

Parent =

State A =

State B =

Individual C =

Licensed Insurer =

l =

m =

n =

Month D =

Year 13 =

Dear

This responds to your letter of February 8, 2002, and subsequent submissions, requesting certain rulings. The requested rulings are that: (1) the administrator obligor service agreements (the contracts) under which Company provides coverage for motor vehicles against mechanical breakdown (beyond the coverage afforded by the manufacturer's and other warranties) qualify as insurance contracts for federal income tax purposes, (2) Company is an insurance company for federal income tax purposes in the year 2001, and (3) Company will be entitled to a deduction under § 832(b)(4) for premiums paid to a licensed insurance company for a policy protecting Company against losses incurred with respect to its obligations under the contracts.

FACTS

In Year 1, Company was incorporated in State A. In year 2001, Company was principally engaged in the issuance of contracts that provided financial protection to the purchasers and lessees of new and used motor vehicles against the mechanical breakdown of those vehicles beyond that covered by the vehicles' (product) warranties. Company is not recognized as an insurance company under the laws of State A. All of the stock of Company is owned by Parent.

Parent is a State B corporation engaged in business primarily as a holding company. Its wholly owned life and property and casualty insurance subsidiaries principally write insurance related to automobile warranty, credit life and credit and health insurance throughout the United States. These contracts are sold through both affiliated and unrelated automobile dealerships. Parent files a calendar year, accrual basis, consolidated federal income tax return as the common parent of an affiliated group of corporations that includes Company and Licensed Insurer. All of the stock of Parent is owned by Individual A.

Licensed Insurer is a State A corporation engaged in business as a property and casualty insurer and licensed in l states. Licensed Insurer writes property and casualty type insurance on a direct basis and assumes (by reinsurance) credit, accident and health insurance from an affiliate. All of the stock of Licensed Insurer is owned by Parent.

The contracts (at issue in this case) provide the customer with protection against economic loss for certain expenses related to vehicle repair not covered by the manufacturer's or other warranty. The contracts also cover a portion of the replacement vehicle rental expense, and towing and road service associated with a mechanical breakdown.[1] Other than the funding of a portion of these road services expenses, towing and replacement vehicle rental costs, the contracts do not cover incidental or consequential damages, such as property damage, personal injury or other costs. The contracts do not cover any preventative or routine maintenance, such as engine tune-up, suspension alignment, filters, or fluids. The contract period is based upon a maximum period of time or a maximum number of miles driven, whichever occurs first.

Under the contracts, the protection is the primary responsibility of Company. With respect to its obligations under the contracts, Company entered into an indemnity agreement with Licensed Insurer who agrees to indemnify Company for 100% of its losses under the contracts. In this relationship, Company retains full responsibility for the risks under the contracts and normally pays all benefits to the policyholders and looks to Licensed Insurer for reimbursement.

The contracts provide, however, that in the event Company cannot provide the protection described in the contract, Licensed Insurer, as the underwriting insurer, is required to provide such protection. Company is primarily liable and Licensed Insurer is secondarily liable if

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[1] The terms of the contracts do not cover parts that are covered by a (product) warranty. Therefore, except for coverage of certain towing and rental replacement costs or those parts that are not covered by a (product) warranty, liability under the contracts does not arise unless the warranty does not cover the loss at all (e.g., a manufacturer's warranty has expired).

Company fails to provide the protection.

During 2001, the principal business within Company consisted of issuing these contracts. The gross receipts received from customers related to the contracts in 2001 exceeded 90% of Company's total gross receipts. Company devoted a substantial number of employees, m, to support its operations. The bulk of the employees engaged in Company's operations, n, assisted in claims handling which includes claim acceptance and payment. Other employees are devoted to such functions as the underwriting of contracts, support issues related to cancellations of contracts, and information technology and information systems. During 2001, Company provided administrative services only with respect to certain other mechanical breakdown contracts under which Licensed Insurer was liable.[2] In addition, Company issued a small number of maintenance contracts (separate from the contracts which are the subject of this ruling letter) that covered preventative and routine maintenance. Company is not seeking rulings with respect to its administrative services only activities or its issuance of preventative maintenance contracts.

The dealerships offer the contracts and, upon the sale of a contract, the dealer collects the entire premium from the contractholder, remits a specific portion of the premium to Company, and retains the balance as "commission." Company does not provide any repair services to the holders of the contracts. Company only reimburses the repairing facilities or the holders of the contracts for costs covered in the contract.

In the event that a policyholder cancels coverage under the contract prior to its expiration date, Company makes a refund to the policyholder. This refund represents the unexpired portion of the total consideration paid by the policyholder pursuant to a formula.

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

[2] Prior to Month D of Year 13, Company was principally engaged in providing administrative services with respect to motor vehicle contracts in which Company was not the obligor.

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 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" for purposes of non-life 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 "[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 (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 an economic loss transfers some or all of the financial consequences of the potential 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 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 as 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 Clougherty Packing Co., 811 F. 2d at 1300.

Based on the information submitted, we conclude that, for federal income tax purposes, the contracts are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the contracts are aleatory contracts under which Company, for a fixed price, is obligated to indemnify the purchaser of the contract for economic loss, not covered by (product) warranties, arising from the mechanical breakdown of, and repair expense to, a purchased motor vehicle. Company's liability is limited to indemnifying the contractholder for losses in the event a mechanical breakdown occurs. Company does not provide any repair services itself and, with respect to the contracts, 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 of other entities (product) warranties. 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 contracts, we find Company's "primary and predominant business activity" during 2001 is the issuing of the contracts, which we conclude are insurance contracts for federal income tax purposes. Thus, Company qualifies as an "insurance company" for purposes of § 831 of the Code for 2001.

CONCLUSIONS

(1) For 2001, the contracts issued by Company, as described above, are 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.

(3) Company will be entitled to a deduction under § 832(b)(4) for premiums paid to Licensed Insurer for a policy protecting Company against losses incurred with respect to its obligations under the contracts.

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 other contracts issued by Company -- separate preventative and routine maintenance contracts or contracts under which it provides only administrative services -- are insurance contracts for federal income tax purposes.

(3) 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 the contracts.

(4) No ruling has been requested, and no opinion is expressed, concerning what amount,

if any, paid by the purchasers of the contracts, and retained by a dealer is deductible as a commission expense by Company.

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, copies of this letter are being sent to your authorized representatives.

Sincerely,
Associate Chief Counsel
(Financial Institutions and Products)
By______/S/___________
MARK SMITH
Chief, Branch 4