Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:4 – PLR-135615-03
Date:
October 01, 2003

Legend:

Taxpayer =

State =
Subsidiary =

Company =
Equipment A =
Equipment B =

Equipment C =
Plan D =
Plan E =

Plan F =
Amount 1 =
Amount 2 =
Amount 3 =

Dear :

This is in reply to your letter of June 3, 2003, requesting rulings that the contracts issued by Taxpayer’s wholly owned subsidiary qualify as insurance contracts for federal income tax purposes and that the subsidiary is taxable under § 831 of the Internal Revenue Code as an insurance company other than a life insurance company.

FACTS

Based on the representations made by Taxpayer, the relevant facts are as follows. Taxpayer is a corporation chartered under the laws of State. Taxpayer uses the calendar year as its taxable year and uses the accrual method of accounting for both its financial records and for federal income tax purposes. Pursuant to § 1362(a), Taxpayer has elected to be an S corporation.

Taxpayer produces Equipment A and Equipment B. Taxpayer provides Equipment A and Equipment B to dealers in automobiles. These dealers install Equipment A and Equipment B on automobiles they sell to retail customers. Taxpayer has caused to be formed Subsidiary in State. The purpose of Subsidiary is to offer extended service protection plans to customers purchasing Equipment A and B, as well as offering an extended service protection plan covering Equipment C, which is not produced by Taxpayer.

With respect to Equipment A, Subsidiary will offer Plan D. If, while Plan D is in force, Equipment A fails in the manner described in Plan D, Subsidiary will pay the contract holder either Amount 1 or Amount 2, depending upon the result of the failure. Subsidiary will reimburse the contract holder for expenses incurred by the contract holder for travel (meals and lodging; airfare; car rental) and for notification to family, business associates, and insurance companies necessitated by the failure. Plan D also provides for a credit of Amount 2 with the retail dealer who sold the contract holder the affected automobile to be used by the contract holder towards the purchase of a replacement automobile from that dealer.

With respect to Equipment B, Subsidiary will offer Plan E. If, while Plan E is in force, Equipment B fails in the manner described in Plan E, Subsidiary will cause to have the resulting damage done to the automobile repaired; however, Subsidiary’s liability for damage done to the exterior of the automobile is limited to the current value of the automobile as reflected in the National Automobile Dealers Association Official Used Car Guide.

With respect to Equipment C, Subsidiary will offer Plan F. If, while Plan F is in force, Equipment C fails in the manner described in Plan F, Subsidiary will cause to have Equipment C repaired or replaced, including installation. In connection with this, Subsidiary will also provide, if appropriate, immediate “roadside” assistance in an amount not to exceed Amount 3. Plan F excludes coverage for more than one event during a seven day period.

For all of the plans, the customer/contract holder pays only the consideration agreed to at the time the plan is issued, and the consideration is not returned to the customer/contract holder if no claim is made. Plan D is non-cancelable and non-refundable. Plan F may be cancelled and if it is cancelled a portion of the consideration will be returned to the contract holder with the amount depending on how long the plan had been in force. Plan E is silent regarding cancellation. None of the plans cover any consequential or other damages suffered by the contract holder, except to the extent stated. The coverage provided by the plans is not a substitute for any warranty made by the manufacturer or seller of the equipment. Subsidiary will not perform any of the repair work contemplated by the plans.

All of the plans are administered and marketed by Taxpayer. Through representatives of Taxpayer, Subsidiary will enter into arrangements with automobile dealers under which the dealers offer for sale Plans D, E, and F. Regardless of the price charged the contract holder for the plan, the dealer must remit to Taxpayer a predetermined amount for each plan sold. Taxpayer will retain a fee as compensation for its services and will remit the balance to Subsidiary. Taxpayer will investigate and process all claims made under the plans. When a claim under Plan E or F is approved by Taxpayer, Subsidiary will reimburse the dealer or other authorized service provider for the parts and labor required to perform the appropriate repair or replacement. When a claim under Plan D is approved by Taxpayer, Subsidiary will pay the appropriate benefit to the contract holder.

In order to comply with applicable state regulation, and to facilitate the conduct of its business, Subsidiary has entered into an agreement with Company, a licensed insurance company, by which Company indemnifies Subsidiary in the event Subsidiary is unable to perform its obligation(s) under the plans.

Subsidiary will generate almost all of its revenue from the sale of the plans since issuing the plans is its primary and predominant business activity.

LAW AND ANALYSIS

Section 831(a) provides that taxes, as computed under § 11, will be imposed on the taxable income (as defined by § 832) of each insurance company other than a life insurance company.

Section 1.831-3(a) of the Income Tax Regulations provides that, for purposes of §§ 831 and 832, the term “insurance companies” means only those companies that qualify as insurance companies under the definition in § 1.801-3(a)(1).

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

Neither the 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, 539 (1941), in which the Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." Case law has defined "insurance" as "involve[ing] a contract, whereby, for an adequate consideration, one party undertakes to indemnify another against loss arising from certain specified contingencies or perils…It 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, 572 F.2d 1190, 1193 (7th Cir.), cert. denied, 439 U.S. 835 (1978).

Risk shifting occurs when a party 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 (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 smoothes out losses to match more closely its receipt of premiums. See Clougherty Packing Co., 811 F.2d at 1300.

Based on the representations concerning Plans D, E, and F, we conclude that, for federal income taxes, Plans D, E, and F are insurance contracts. The plans are aleatory contracts under which Subsidiary is obligated to indemnify the contract holders for economic loss arising from the mechanical breakdown of a piece of equipment that is not covered by the manufacturer's warranty. The plans are not prepaid service contracts because Subsidiary does not perform any repair services. By accepting a large number of risks, Subsidiary has distributed the risk of loss under the contracts so as to make the average loss more predictable.

Based on the representations concerning its business activities, we conclude that Subsidiary will qualify for purposes of § 831 as an insurance company other than a life insurance company so long as its primary and predominant business activity is issuing the plans.

CONCLUSIONS

1. Plans D, E, and F are insurance contracts for federal income tax purposes.

2. Subsidiary will qualify as an insurance company for purposes of § 831 so long as issuing Plans D, E, and F is its primary and predominant business activity.

CAVEATS

1. Except as expressly provided herein, no opinion is expressed or implied 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 Subsidiary's gross premiums written include the entire amount the purchasers of Plans D, E, and F pay to the Taxpayer for the contracts.

3. No opinion is expressed concerning the purpose and motive of the transaction or the application of §§ 482 or 845 to the transaction.

Section 6110(k)(3) of the Code provides that this letter may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the first listed representative.

Sincerely,

/S/

THOMAS M. PRESTON
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)