Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
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Refer Reply To:
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Date:
September 30, 2003

Legend:

Taxpayer =

State A =
Equipment B =
Company C =
Plan D =
Pan E =

Dear :

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

FACTS

Taxpayer is a corporation chartered under the laws of State A. Taxpayer operates as a distributor of Equipment B, and accessories and parts for Equipment B. Taxpayer sells, leases, and repairs these products. Most of Equipment B and the related accessories and parts carried by

Taxpayer are manufactured by Company C. 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. Taxpayer has elected pursuant to § 1362(a) to be an S corporation.

In addition to manufacturing Equipment B and related accessories and parts, Company C offers to purchasers of Equipment B an agreement providing coverage in the event of the mechanical breakdown of Equipment B. This coverage is intended to supplement the manufacturer's warranty Company C provides with Equipment B. Taxpayer has acted as an agent of Company C in selling this coverage to purchasers and lessees of Equipment B. Taxpayer wishes to diversify its business activities and to issue agreements similar to those offered by Company C.

Taxpayer proposes to form a corporation (hereafter "Insurance Subsidiary") pursuant to the laws of State A. Taxpayer will be the sole shareholder of Insurance Subsidiary. Taxpayer will not elect under § 1361(a)(3)(B)(ii) to treat Insurance Subsidiary as a qualified subchapter S subsidiary.

Insurance Subsidiary will offer two mechanical breakdown agreements to customers of Taxpayer who purchase/lease Equipment B: Plan D and Plan E. These plans will be a contract between the customer and Insurance Subsidiary. The plans will be in force for a specified period of time, and both indicate that they run concurrently with, and have no effect on, any warranty provided by Company C. The plans provide for the repair or replacement of parts of Equipment B which fail during the period the plan is in force. This repair or replacement must be performed by Taxpayer. The plans do not provide for any compensation or reimbursement for any other losses or expenses, including indirect or consequential damages, incurred by the customer as a result of the failure of a covered part. The plans cover only parts which have been inspected and determined to have been defective in material or workmanship. The plans do not cover routine maintenance nor cover the cost of transporting Equipment B to Taxpayer for the performance of the appropriate repair or replacement of a covered part. Plan D covers Equipment B's powertrain; Plan E covers the entire piece of equipment. Insurance Subsidiary will not perform any repair or replacement work itself; that work will be performed by Taxpayer with Insurance Subsidiary satisfying Taxpayer's charge for such work.

The plans will be offered to customers at the time Equipment B is sold or leased. In the event a customer purchases a plan but decides to cancel it before expiration, Insurance Subsidiary will refund to the customer the purchase price allocable to the unexpired portion of the plan.

Insurance Subsidiary will issue a large number of plans. It is anticipated that the purchasers of the plans will be unrelated to Company C, Taxpayer, and Insurance Subsidiary. It is also anticipated that for certain pieces of Equipment B, Taxpayer will continue to offer to customers the opportunity to purchase the agreements issued by Company C.

Insurance Subsidiary will not be recognized as an insurance company under the laws of State A. However, it is anticipated that Insurance Subsidiary's operations will, to the extent possible, be consistent with that state's captive insurance company act. The fees to be charged for the plans, the amount of capital surplus maintained, and the amount of loss reserves, will be determined no less frequently than annually by an independent actuary. Additionally, Insurance Subsidiary's financial records will be audited annually by a certified public accountant. Insurance Subsidiary will employ a sufficient number of employees to support its operations. The employees will perform functions including contract underwriting, claims administration, contract cancellation, and information technology. Insurance Subsidiary anticipates that its gross receipts from issuing the plans will comprise the substantial majority of its total gross receipts. Taxpayer will provide no guarantee of Insurance Subsidiary's ability to perform its obligations under the plans.

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 former § 1.801-1(b) (now § 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 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 (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 information submitted, we conclude that, for federal income taxes, Plans D and E are insurance contracts. The plans are aleatory contracts under which Insurance Subsidiary, for a fixed price, is obligated to indemnify the contract holder for economic loss not covered by the manufacturer's warranty, arising from the mechanical breakdown of, and repair expense to, a piece of Equipment B due to a defective part. The plans are not prepaid service contracts because Insurance Subsidiary does not perform any repair services. By accepting a large number of risks, Insurance 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 Insurance Subsidiary's primary and predominant business activity will be issuing the plans, which we have concluded are insurance contracts for federal income tax purposes. Therefore, under § 1.801-3(a)(1), Insurance Subsidiary will qualify as an insurance company for purposes of § 831 so long as its primary and predominant business activity is issuing the plans.

CONCLUSIONS

1. Plan D and Plan E are insurance contracts for federal income tax purposes.

2. Insurance Subsidiary will qualify as an insurance company for purposes of § 831 so long as issuing Plans D and E 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 Insurance Subsidiary's gross premiums written include the entire amount the purchasers of Plans D and E 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 it 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 Taxpayer.

Sincerely,

/S/

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MARK SMITH
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)