Internal Revenue Service

Number: **200509005**
Release Date: 3/4/05
Index Number: 832.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B04
PLR-127932-04
Date:
November 17, 2004

<u>Legend</u>

Company =

State A =

State B =

State C =

R =

Corporation X =

Corporation Y =

Bank Z =

Dear

This responds to a letter dated May 18, 2004, and subsequent correspondence respectively dated July 8, September 17, and September 29, 2004, requesting rulings as to: (1) whether vehicle service agreements (VSAs) issued by Company will qualify as insurance contracts for federal income tax purposes, and (2) whether Company will be treated as an insurance company for federal income tax purposes.

FACTS

Company is incorporated in State A, but is not recognized as an insurance company under the laws of State A. Company proposes to issue VSAs that will provide coverage for the mechanical breakdown of certain new and used motor vehicle products which exceeds the coverage of any warranty provided by a manufacturer, or a guaranty or warranty provided by a repairer. The VSAs will indemnify the VSA purchaser for the costs of motor vehicle mechanical breakdowns if such breakdowns are caused by a failure of a covered part in normal use. In this regard, Company offers several levels of coverage from basic power train coverage to a variety of coverages that include additional mechanical parts. For example, Company's basic power train coverage does not cover a mechanical breakdown of the vehicle's air conditioning system whereas more extensive VSA programs offered by Company will provide such coverage. On the other hand, Company's VSAs do not provide for routine maintenance such as engine tune-ups, oil changes and tire rotation.

The VSAs will be sold by the sales personnel of the R dealerships who will act as Company's agent with respect to selling the VSAs. Company's customer base will be the customers of R affiliates who purchase new and used motor vehicles and who purchase the VSAs. The purchasers of the VSAs will have the option to pay for the VSA premium in full or on a monthly payment basis. Company will neither service, nor sell or manufacture motor vehicles covered by the VSAs. Company's only business activity will be the issuing of VSAs and related procedures such as providing general supervision over the claims process with respect to the VSAs.

The sales personnel at the R dealership will sell the VSAs to their customers at a negotiated price and will retain a portion of the price as a commission for the sale of the VSA. The remainder of the amount collected will be remitted to Company to be used for various purposes. Company will use a portion of the amount remitted to pay an administration fee to Corporation X. Corporation X is a State B corporation that is engaged in the business of a third party administrator with expertise in adjudicating mechanical breakdown claims. Another portion of the fee remitted to Company will be used to purchase indemnification from Company Y, licensed as an insurance company in State C, that will indemnify the purchasers of the VSAs in case of a default by the Company. The remaining portion of the amount remitted to Company will be maintained in a custodial account in Company's name at Bank Z as reserves from which to pay claims arising under the VSAs.

In connection with the above transaction, it is represented as follows:

(1) Company has amended the VSA (submitted as an attachment to its request for letter ruling) to make clear that Company (and not the automobile dealers) is solely liable under the VSAs.

(2) Company represents that the amended VSA will be used in transactions to which this ruling relates.

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 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 831(c) provides that, for purposes of § 831, the term “insurance company” has the meaning given to such term by §816(a).

Under § 816(a), the term “insurance company” means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

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 (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, 45, as modified by Rev. Rul. 2001-31, 2001-1 C.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 (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 Cloughtery Packing Co., 811 F.2d at 1300.

Based on the information submitted, we conclude that, for federal income tax purposes, the VSAs are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the VSAs are aleatory contracts under which Company, for a fixed price, is obligated to indemnify the purchaser of the VSA for economic loss not covered by warranties provided by a manufacturer, arising from the mechanical breakdown of, and repair expense to, a purchased motor vehicle. Thus, the VSAs are not prepaid service contracts because Company's liability is limited to indemnifying the VSA contractholder for losses in the event a mechanical breakdown occurs. Company does not provide any repair services itself. Further, by accepting a large number of risks, Company has distributed the risk of loss under the VSAs so as to make the average loss more predictable.

Based on Company's representations concerning its business activities in providing the VSAs, we find that more than half of Company's business during the taxable year will be the issuing of VSAs that are insurance contracts for federal income tax purposes. Thus, Company will qualify as an "insurance company" for purposes of § 831.

CONCLUSIONS

(1) The VSAs to be issued by Company will be insurance contracts for federal tax purposes.

(2) Company will be an insurance company within the meaning of § 831 so long as more than half of Company's business during the taxable year consists of issuing the VSAs.

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 VSAs 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 VSAs, and retained by an R dealership is deductible as a commission expense by Company. (4) No opinion has been requested and no opinion is expressed as to the tax characterization of any payments that Company makes to Corporation Y.

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 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,
/S/

THOMAS M. PRESTON
Senior Counsel, Branch 4
(Financial Institutions & Products)