Internal Revenue Service

Number: **201802004**
Release Date: 1/12/2018

Index Number: 831.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

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Refer Reply To:
CC:FIP:B04
PLR-112892-17

Date:
October 16, 2017

Taxpayer	=
Obligor	=
Insurer	=
Guarantor	=
Initial Reinsurer	=
Claims Administrator	=
State W	=
State X	=
Country 1	=
Country 2	=
Agreement 1	=
Agreement 2	=
Agreement 3	=

Dear :

This letter is in response to the request, submitted by your authorized representative, for rulings on the federal income tax treatment of certain contracts under Part II of Subchapter L of the Internal Revenue Code.

FACTS

Taxpayer is a Country 1 corporation. It is not licensed or recognized as an insurance company under Country 1 law or the law of any state in the United States. Pursuant to Agreement 1, Taxpayer will acquire the risk under Vehicle Service Contracts ("VSCs") but will not sell VSCs nor sell, repair, or manufacture vehicles. Taxpayer will make a

§ 953(d) election to be treated as a U.S. insurance company for federal income tax purposes and will report its underwriting and investment income on a Form 1120-PC.

Motor vehicle dealers ("Dealers") sell VSCs to eligible motor vehicle purchasers ("Consumers"). Purchasing a VSC is optional and the cost is not included in the purchase price of the vehicle. The VSCs provide coverage for a pre-determined period of time or for a pre-determined number of miles driven, whichever comes first. The VSCs provide Consumers with financial protection against economic loss for certain repair costs by covering the cost of repairs or by reimbursing Consumers for the cost of parts and labor to repair or replace covered parts. The VSCs also cover a portion of towing costs, incidental extra expenses related to trip disruption, and costs for a rental replacement automobile. Consumers obtain VSC covered services from Dealers or another service provider. The VSCs are not prepaid service contracts, and they do not cover routine preventive maintenance. The VSCs also do not cover repairs covered by a manufacturer's warranty and, except as stated above, do not cover incidental or consequential damages such as property damage, personal injury, inconvenience, or loss of vehicle use.

If the consumer purchases a VSC, the risk of the unexpected equipment failure transfers to Obligor, the other party to the VSCs. When there is a breakdown on a vehicle covered by a VSC, Obligor is responsible for the economic loss that otherwise would have been borne by the Consumer.

The following arrangements are in place, or will be entered into, with respect to the VSCs:

1) Obligor's duties under the VSCs are guaranteed by an insurance policy Obligor enters with Guarantor, a State W corporation, which is unrelated to Obligor.[1]

2) Obligor will enter into Agreement 2 with Insurer, a State X captive insurance company, to transfer 100 percent of its risk under the VSCs. Obligor and insurer are wholly owned by a common parent.

3) Insurer will enter into Agreement 3 with Initial Reinsurer, a Country 2 insurance company, to transfer 100 percent of its risk under the VSCs.

4) Under Agreement 1, Initial Reinsurer will transfer 100 percent of its risk under the VSCs to Taxpayer.

[1] In the event Obligor ceases to operate, is bankrupt or otherwise financially impaired, or a claim or contract cancellation refund is not paid within sixty days after proof of loss has been filed, the Consumer may file a direct claim with Guarantor.

Pursuant to Agreement 1, Initial Reinsurer will remit to Taxpayer a predetermined arms-length amount for each VSC. Neither Obligor, Insurer, Initial Reinsurer, nor Taxpayer will provide repair services under the VSCs.

Claims Administrator will investigate and process all claims for covered repair made under the VSCs. As claims are made and approved, Insurer will reimburse Obligor. In turn, Initial Reinsurer will reimburse Insurer the amount it paid to Obligor and, in accordance with Agreement 1, Taxpayer will reimburse that amount to Initial Reinsurer.

Insurer and Initial Reinsurer are brother-sister entities of the same control group. Taxpayer is unrelated to the Dealers and is not in the same controlled group as Insurer and Initial Reinsurer. However, the individual who owns Taxpayer is a minority owner of the holding company that owns Insurer and Initial Reinsurer.

Taxpayer represents that:

1) More than half its business during the taxable year will be reinsuring Initial Reinsurer's risk under the VSCs; and

2) For federal income tax purposes, it will account for the VSC premiums it receives, the related unearned premiums, the related unpaid losses, and other items of income and deductions in accordance with § 832.

LAW AND ANALYSIS

Section 831(a) provides that taxes, computed as provided in § 11, are imposed for each taxable year on the taxable income of every insurance company other than a life insurance company. Section 831(c) defines the term "insurance company" for purposes of § 831 as having the same meaning as that term is given under § 816(a). Section 816(a) provides that 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 Internal Revenue Code, nor Treasury regulation, define "insurance" or "insurance contract" for federal income tax purposes. In the seminal case addressing this subject, the United States Supreme Court reasoned that in order for a transaction to qualify as insurance

> the amounts must be received as a result of a transaction which involved an actual 'insurance risk' at the time the transaction was executed. Historically and commonly insurance involves risk-shifting and risk-distributing . . . That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators.

Helvering v. Le Gierse, 312 U.S. 531, 539 (1941). Subsequent cases, in analyzing whether premiums paid to captive insurance companies are deductible, have considered whether the transaction constitutes insurance in its "commonly accepted sense" and whether the risk transferred is an "insurance risk" to establish a framework for determining whether an arrangement will be respected as insurance for federal tax purposes. R.V.I. Guaranty Co., LTD v. Commissioner, 145 T.C. 209, 224-25 (2015). See also, Rent-A-Center, Inc. v. Commissioner, 142 T.C. 1, 13-14 (2014).

The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). Courts consider "all of the facts and circumstances to determine whether an arrangement qualifies as insurance." Rent-A-Center, 142 T.C. at 22 (citing Harper Group v. Commissioner, 96 T.C. 45 at 57 (1991)).

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. 2005-40, 2005 C.B. 4, 7. 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 occurs when an insurer pools a large enough collection of unrelated risks (those unaffected by the same event) and distributes the risks among the policyholders. Rent-A-Center, 142 T.C. at 24; Avrahami v. Commissioner, 149 T.C. No. 7, at 60. A captive may achieve adequate risk distribution by insuring only subsidiaries within its affiliated group. Id. But see Rev. Rul. 2005-40, 2005-4 C.B. 4 (holding that where only one entity participates as the insured, the arrangement lacks sufficient risk distribution). In analyzing risk distribution, there must be both a sufficient number of insured companies as well as a sufficient number of independent risk exposures. Avrahami, 149 T.C. No. 7 at 63-64.

In Situation 1 of Rev. Rul. 2009-26, 2009-2 C.B. 366, the Service considered a ninety percent quota share arrangement between a ceding company with 10,000 policyholders and a reinsurer that had no other business. The Service concluded that the reinsurance contract between the ceding company and the reinsurer shifted risk to the reinsurer and distributed risk among the 10,000 policyholders the ceding company insured. Accordingly, the reinsurer qualified as an insurance company because it reinsured risks underwritten by an insurance company and assuming these risks constituted more than half of its business for the year.

To determine whether an arrangement constitutes insurance in its commonly accepted sense, factors to consider are: (1) whether the insurer is organized, operated, and regulated as an insurance company by the states or jurisdictions in which it does business; (2) whether the insurer is adequately capitalized; (3) whether the insurance policies are valid and binding; (4) whether the premiums are reasonable in relation to the risk of loss; and (5) whether premiums are duly paid and loss claims are duly satisfied. R.V. I. Guaranty Co., Ltd, 145 T.C. at 231; Rent-A-Center, 142 T.C. at 24-25.

We conclude that, for federal tax purposes, Taxpayer's agreement, Agreement 1, with Initial Reinsurer is an insurance contract for federal income tax purposes. Pursuant to Agreement 1, Taxpayer acquires risks under the VSCs. Obligor does not provide repair services under the VSCs and the VSCs are not prepaid service contracts. Under the VSCs, for a fixed price, Obligor is obligated to indemnify the Consumer for economic loss not covered by the manufacturer's or other warranty arising from the mechanical breakdown of, and repair expense to, a purchased or leased motor vehicle. The VSCs shift the Consumers' risks of loss due to mechanical failure to Obligor. Obligor is the obligor under the VSCs issued to a substantial number of individual Consumers. The VSCs cover a substantial number of motor vehicles. Therefore, the risks will be distributed across a large number of insureds and risk exposures. Obligor transfers these risks to Insurer. Insurer transfers these risks to Initial Reinsurer, and Initial Reinsurer will transfer these risks to Taxpayer. These reinsurance transactions are similar to the one described in Situation 1 of Rev. Rul. 2009- 26 because, by "looking through" the reinsurance arrangements to the original Consumers, the risks ultimately assumed by Taxpayer will be distributed among a large number of insured.

In addition to having insurance risk, risk shifting, and risk distribution, based on the facts described above, the arrangement constitutes insurance in its commonly accepted sense.

HOLDINGS

Based on the information submitted and Taxpayer's representations:

1) Taxpayer's agreement, Agreement 1, with Initial Reinsurer is an insurance contract for federal income tax purposes.

2) Provided that at the end of each taxable year more than half of Taxpayer's business is reinsuring the VSCs, Taxpayer will qualify as insurance company for that taxable year for purposes of § 831.

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. The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings, and it is subject to verification on examination. This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Rebecca L. Baxter
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)