INTERNAL REVENUE SERVICE
UIL:0831.00-00
Number: **199926033**
Release Date: 7/2/1999

CC:DOM:FI&P:4/PLR-122660-98
APRIL 7, 1999

Taxpayer =

State R =

Manufacturer X =

Manufacturer Y =

Manufacturer Z =

A =

a =

b =

c =

d =

e =

f =

g =

h =

k =

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Dear

This is in reply to your letter dated December 15, 1998, requesting a ruling that Taxpayer is taxable as an insurance company and subject to the provisions of parts II and III of Subchapter L of the Internal Revenue Code of 1986, as amended.

FACTS

Taxpayer is a State R corporation regulated by the State R Department of Insurance. Taxpayer is a wholly-owned stock subsidiary of A and joins in filing a consolidated income tax return on the basis of A's fiscal year ending September 30.

Taxpayer operates nationwide and is regulated by the Insurance Departments in 30 states. Taxpayer originally operated as a conventional automobile club providing towing in the event of mechanical breakdown, emergency roadside assistance, trip planning, and other travel-related services to individual motorists in exchange for annual prepaid membership dues. Taxpayer has expanded its services to include not only the trip planning and retail program, but also "private label emergency service" (Wholesale Programs).

Taxpayer represents that currently less than l of its contracts provide trip planning/routing services and that m of its revenue is derived from roadside assistance and related services (Retail Program). The fee for the Retail Program is a. The Wholesale Programs represent the majority of contracts. The Wholesale Programs are provided in the names of the automotive manufacturers and are limited to roadside assistance services. The manufacturers include Manufacturer X, Manufacturer Y, and Manufacturer Z.

Taxpayer sells two types of contracts. The most common type is referred to as the "Risk Based Contract". The contracts with Manufacturers X and Y are examples of Risk Based Contracts, and are described below in further detail. In the case of the Risk Based Contract, Taxpayer is paid a specific amount, either directly by the member under the Retail Programs (individual memberships) or by the automotive manufacturers under the Wholesale Programs (automotive manufacturer contracts). Generally, Taxpayer is responsible for providing the roadside assistance service at its expense regardless of the number of breakdowns any one motorist may have. Taxpayer is financially at risk with respect to each individual Risk Based Contract as any one vehicle may require emergency assistance numerous times, resulting in service costs exceeding contract fees. Total contract fees are sufficient to cover the cost of such service based on projected claims and historical experience. Taxpayer represents that for the year ended September 30, 1998, approximately n of its revenue is from Risk Based Contracts.

The second type of contract is the No Risk Contract. The contract with Manufacturer Z is an example of a No Risk Contract. As described below, the automobile manufacturer is responsible for the cost for any dispatch and emergency roadside service. Therefore, under the No Risk Contract, the risk is retained by the automobile manufacturer.

Taxpayer also maintains a 24-hour toll free 800 number to ensure prompt delivery of emergency roadside assistance services to motorists. Taxpayer has created a network of towing operators and locksmiths. The contractual arrangement between Taxpayer and the tow operators and locksmiths is standardized at volume based rates on a fee-for service basis. The towing operators and locksmiths who perform the actual roadside assistance are independent contractors, not employees of Taxpayer.

Manufacturer X Contracts

Approximately k of Taxpayer’s revenue for the period ending September 30, 1998 is from its contracts with Manufacturer X. These contracts provide emergency roadside assistance service under Extended Warranty Service Contracts and the Basic Warranty Plan to Manufacturer X’s customers.

In 1997, Taxpayer and Manufacturer X entered into a new contract to cover emergency roadside service provided to customers under the Basic Warranty Plan. The new contract offers emergency roadside services to drivers of Covered Vehicles (all new motor vehicles designated by Manufacturer X as 1998, 1999 or 2000 Model Year Manufacturer X motor vehicles that are models for delivery in the United States) for a period of three (3) years or thirty six thousand (36,000) miles, whichever occurs first.

Under the terms of the agreements, Manufacturer X will pay Taxpayer b per Covered Vehicle as the basic fee for providing services to Manufacturer X and to customers. The basic fee will be Taxpayer's total compensation from Manufacturer X for providing services regarding a Covered Vehicle. The basic fee is payable monthly to Taxpayer. However, if the cumulative number of dispatches regarding Covered Vehicles manufactured in a given model year exceeds the applicable Model Year Cap (c of the Covered Vehicles manufactured by or for Manufacturer X for delivery in the United States for such model year), Manufacturer X will reimburse Taxpayer for actual payments made by Taxpayer to a service provider for rendering roadside assistance upon each such additional dispatch. No additional fee is paid for dispatch as was provided for in the 1994 contract. In the event the dispatches fall below the applicable Model Year Cap, Taxpayer will provide Manufacturer X a credit of d per covered vehicle for each one percent of usage that falls below the applicable Model Year Cap.

The emergency roadside assistance services provided by Taxpayer pursuant to the contracts with Manufacturer X are comprised of the following: (1) gasoline refill up to two gallons of gasoline; (2) locksmith services for automobile lockouts; (3) flat tire change; (4) battery recharge or a jump start; and (5) towing service to the nearest Manufacturer X-branded dealership of another Manufacturer X-branded dealership no more than twenty-five miles more distant than the nearest Manufacturer X branded dealership, if requested by customer.

In addition, Manufacturer X will pay Taxpayer e per call under the 1997 contract for each telephone call by a customer to a toll free 800 number that is not related to such customer receiving emergency roadside services.

Manufacturer Y

Taxpayer’s contract with Manufacturer Y is also a risk based contract. Manufacturer Y pays to Taxpayer h annually per vehicle sold or leased by a Manufacturer Y dealership. In return, Taxpayer agrees to provide emergency roadside services including towing to the nearest Manufacturer Y dealership in any instance where a covered vehicle is disabled due to a problem covered under the warranty. In the event that a Manufacturer Y dealership is not available to receive the vehicle, Taxpayer shall arrange for the vehicle to be towed to a place for safekeeping until such dealership may accept the vehicle. The responsibility for the expenses for such roadside services are entirely borne by Taxpayer. In the event that a customer refuses to give the vehicle towed to the nearest Manufacturer Y dealership, such customer shall be responsible for arranging for services.

Manufacturer Z

Taxpayer’s contract with Manufacturer Z is a no risk contract. Taxpayer charges a data base fee of f for each Manufacturer Z vehicle sold. Costs associated with emergency roadside service are passed on to and paid by Manufacturer Z. Specifically, Taxpayer charges Manufacturer Z a g dispatch fee plus the service cost with respect to emergency roadside service.

LAW AND ANALYSIS

Section 831(a) of the Internal Revenue Code provides that taxes computed under section 11 are imposed for each tax year on the taxable income of every insurance company other than a life insurance company.

Section 1.831-3(a) of the Income Tax Regulations provides, in part, that for purposes of sections 831 and 832, the term "insurance companies" means only those companies which qualify as insurance companies under former section 1.801-1(b) of the regulations (now section 1.801-3(a)).

Section 1.801-3(a) 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. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

Whether an entity is an insurance company for Federal income tax purposes depends on the character of the business actually done in the taxable year. If an entity is primarily engaged in the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies, then the entity is subject to tax as an insurance company regardless of its classification under state law. Section 1.831-3(a) and 1.801-(3)(a)(1) of the Income Tax Regulations; Rev. Rul. 83-172, 1983-2 C.B. 107; Rev. Rul. 71-404, 1971-2 C.B. 260. <u>See also</u>, <u>Bowers v. Lawyers Mortgage Co.</u>, 285 U.S. 182 (1932).

Neither section 832 of the Code nor the regulations thereunder define the terms "insurance" or "insurance contract." The accepted definition of "insurance" for Federal tax purposes is found in <u>Helvering v. Legierse</u>, 312 U.S. 531 (1941), in which the Supreme Court states that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." <u>Id</u>. at 539. Case law has defined an insurance contract as "a contract whereby, for an adequate consideration, one party undertakes to indemnify another against loss arising from certain specified contingencies or perils... . [I]t is contractual security against possible anticipated loss." <u>Epmeier v. United States</u>, 199 F.2d 508, 509-10 (7th Cir. 1952). In addition, the risk transferred under the contract must involve the assumption of another's risk of economic loss. <u>Allied Fidelty Corp. v. Commissioner</u>, 66 T.C. 1068 (1976), <u>aff'd</u> 572 F.2d 1190 (7th Cir. 1978), <u>cert denied</u>, 439 U.S. 835 (1978); Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs when the insured, facing the possibility of an economic loss, transfers part or all of the financial consequences of the loss to the insurer. If the insured has shifted its risk to the insurer, then a loss does not affect the insured because the loss is offset by the proceeds of an insurance payment. See Rev. Rul. 88-72, 1988-2 C.B. 31, clarified by Rev. Rul. 89-61, 1989-1 C.B. 75.

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Clougherty Packing, 811 F.2d 1297, 1300 (9th Cir.1987). The insurer assumes a risk of loss as part of a plan to distribute actual losses among a large group of persons with similar risks. When additional statistically independent risk exposures are insured, an insurance company's potential total loss increases, as does the uncertainty regarding the amount of that loss. As the uncertainty regarding the company's total loss increases, however, there is an increase in the predictability of the insurance company's average loss (total loss divided by the number of exposure units). That is, when the sample number increases, the probability density function of the average loss tends to be more concentrated around the mean. Due to this increase in predictability, there is a downward trend in the amount of capital that a company needs per risk unit to remain at a given level of solvency. See Rev. Rul. 89-61.

While risk shifting and risk distribution are essential to the concept of insurance, judicial decisions have made it clear that not all business transactions which involve an element of risk to the contracting parties involve insurance. More specifically, judicial decisions have made it clear that the sale of goods or services through the negotiation of a discounted fee does not constitute insurance. Although the seller of goods or services might sustain a loss from the transaction, the seller is presumed to exercise sufficient control over the events that produce the loss (i.e., the cost of furnishing the goods or services in question) so that no loss occurs on account of a fortuitous event.

In Jordan v. Group Health Ass'n, 107 F.2d 239 (D.C. App. 1939), the court discussed the difference between a business risk and an insurance risk in holding that Group Health's contracts did not involve the provision of insurance. The court noted that insurance primarily "involves contractual security against risk of loss," whereas a health service contract is not insurance if it is concerned primarily with getting services rendered to its members and doing so at lower prices made possible by quantity purchasing and economies in operation." 107 F.2d at 247. The court further stated that the presence of an "incidental element" of risk does not in and of itself render a health service contract one of insurance. 107 F.2d at 247-248. Thus, the elements of risk shifting and risk distribution must be central to the main purposes of the transaction.

The contract between Taxpayer and Manufacturer Z is an example of a fee-for-service arrangement, which does not involve a shifting of insurance risk. Under the contract, Taxpayer agrees to provide dispatch and referral services to consumers of Manufacturer Z vehicles at a prospectively set rate. Taxpayer charges Manufacturer Z a g fee for each dispatch. The actual costs of providing emergency roadside assistance services to consumers are passed on to Manufacturer Z. This type of contract is a service contract.

The contracts between Taxpayer and Manufacturers X and Y are insurance contracts. Under the contracts between Taxpayer and Manufacturers X and Y, Taxpayer, for a fixed price, is obligated to indemnify a contractholder for the economic loss arising from any emergency roadside assistance during the contract period. By accepting a large number of risks, Taxpayer distributes the risk of loss under the contracts so as to make the average loss on a contract more predictable. Because issuance of Risk Based Contracts, such as those with Manufacturers X and Y represent Taxpayer’s primary and predominant business, Taxpayer qualifies to be taxed as an insurance company.

CONCLUSION

Accordingly, Taxpayer is taxable as an insurance company and subject to the provisions of Parts II and III of Subchapter L of the Internal Revenue Code of 1986, as amended.

No opinion is expressed under other sections of the Code and income tax regulations which may also apply.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the next federal income tax return to be filed by Taxpayer.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions
and Products)

By: SIGNED BY MARK S. SMITH
Mark S. Smith
Chief, Branch 4