Internal Revenue Service

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Washington, D.C. 20224

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Legend

Parent -

State 1 -

State 2 -

Administrator -

Primary Obligor -

X Insurance Company -

Grandparent -

Fund -

Guaranty Policy -

Dear

This responds to the letter dated January 26, 1999 (and to the supplemental letters dated February 24th, March 29th, April 14th, 19th, 20th, and 26th, 1999) submitted to the Internal Revenue Service on behalf of Parent by its representative. That January 26th letter requested rulings that for purposes of federal income tax law and section 831 of the Internal Revenue Code, the contracts pursuant to which Primary Obligor provides coverage for a manufactured product against mechanical breakdown beyond the coverage afforded by the manufacturer's warranties qualify as insurance contracts, and that Primary Obligor will be treated as an insurance company. The supplemental letters provided additional information to the Internal Revenue service in connection with that request.

Parent, a State 1 holding company, is the parent of a consolidated group that includes Primary Obligor and X Insurance Company, both State 2 corporations. Parent owns 100% of the stock of both Primary Obligor and X Insurance Company. Primary Obligor is in the business of issuing new and used vehicle extended service agreements (ESAs) relating to new and used automobiles to the general public. Members of the general public (consumers) purchase those ESAs through unrelated automobile dealers (Dealers). When a consumer purchases a new or used automobile from a participating Dealer, the Dealer will offer them an ESA. An ESA offers the purchaser (the Contractholder) protection against economic loss for expenses related to mechanical breakdown and repair of a covered vehicle. The ESAs also cover a portion of the towing costs and costs of a rental replacement automobile, but do not cover incidental or consequential damages such as property damage, personal injury, inconvenience or loss of vehicle use. There is no obligation under an ESA to pay the costs of repair that are covered by a manufacturer's warranty.

The ESAs are administered by Administrator. Administrator is wholly owned by Grandparent, which also owns Parent. Administrator is ineligible to join in the filing the federal consolidated return which includes Taxpayer's income and expenses. Administrator is responsible for preparing weekly claims paid and claims pending reports, supplying forms, advertising and promotional materials, and investigating and processing all claims presented under the ESA program.

The relationship between a Contractholder, a Dealer, Administrator, Primary Obligor, and X Insurance Company is detailed, in part, under the Other Important Contract Provisions term of the ESAs, as follows:

> In return for your payment for this Agreement, and subject to its terms, you will be provided the protection described herein. The selling dealers agree that all sums paid by You under the terms of this Agreement, excluding a commission retained by the Selling Dealer, will be submitted on your behalf to the Administrator, [Primary Obligor]. . . and others, and [Primary Obligor] will be primarily liable to You for payment of valid claims under this Agreement.
>
> YOUR BENEFITS UNDER THIS AGREEMENT ARE INSURED BY [X INSURANCE COMPANY]. . . .

Under the terms of an ESA, Primary Obligor reimburses the Dealer for covered repair costs (less the stated deductible to be paid by the Contractholder) for parts and labor. Primary Obligor does not provide repair services to the Contractholder, but merely reimburses the repairing facility for costs of automotive repairs covered under an ESA.

The Dealer negotiates with the Contractholder the amount the Contractholder is charged in connection with the Contractholder's acquisition of an ESA. Regardless of the amount the Contractholder pays, the Dealer must remit to Administrator a set amount for each ESA sold. The Dealer is entitled to retain the difference between that set amount and the amount the Contractholder pays in connection with the acquisition of the ESA. From the amounts remitted by the Dealer, Administrator pays a designated amount to Primary Obligor which agrees to pay all covered claims. A portion of the amount remitted by the Dealer is retained by Administrator as a fee, and a portion is paid by Administrator, on behalf of Primary Obligor, to X Insurance Company. Primary Obligor states that its primary business activity consists of the issuance of ESAs and that its sole revenues consist of the funds paid to it in consideration of its obligation to pay all covered claims under the ESAs, and the investment income on such funds.

In the event a Contractholder cancels coverage under an ESA prior to its expiration date, Primary Obligor makes a payment to the Contractholder of an amount equal to a portion of the ESA's purchase price, pursuant to a stated formula. The Dealer is required to reimburse Primary Obligor for a portion of that payment. That portion is computed with reference to the amount retained by the Dealer on the sale of the relevant FSA.

Apart from the amount attributable to the difference between the set amount the Dealer is required to remit to the Administrator and the amount the Contractholder pays in order to obtain the ESAs, the Dealer may be entitled to receive certain "experience payments" from Primary Obligor. The Dealer, Primary Obligor and Administrator enter into a Experience Payment Agreement detailing the method of computing those payments which are stated to be based on the performance of the Fund. The Experience Payment Agreement is intended to control the costs of labor and parts by providing an incentive to Dealers that only reasonable and necessary repairs are made to covered vehicles.

All benefits payable under the ESAs by Primary Obligor are guaranteed by X Insurance Company pursuant to a Guaranty Policy. X Insurance Company is subject to regulation as an insurance company in State 2. In the event Primary Obligor is unable to satisfy a valid loss claim under the ESAs, X Insurance Company guarantees payment of the claims to the Contractholders. X Insurance company is entitled to indemnification from, or subrogation against, Primary Obligor if X Insurance Company pays any sum which Primary Obligor is required to pay under the ESAs.

Rulings Requested

Taxpayer requests a ruling that for purposes of the federal income tax law and Section 831, (i) the ESAs qualify as insurance contracts and (ii) Primary Obligor qualifies as an insurance company.

Applicable Law and Rationale

Whether an entity is an insurance company for federal income tax purposes depends on the character of the business it actually does in the taxable year. Section 1.831-3(a) of the regulations states that for purposes of §§ 831 and 832, the term "insurance company" means only those companies which qualify as insurance companies under former § 1.801-1(b) (now § 1.801-3(a)(1)) of the regulations.

Section 1.801-3(a)(1) of the regulations states 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.

Whether an entity is an insurance company for federal income tax purposes depends on the character of the business it actually does 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. Sections 1.831-3 and 1.801-3(a)(1) of the regulations; Rev. Rul. 83-172, 1983-2 C.B. 106; Rev. Rul. 71-404, 1971-2 C.B. 260. See also, Bowers v. Lawyers Mortgage Co., 285 U.S. 182, 188 (1932); Commissioner v. W. H. Luguire Burial Ass'n Co., Inc., 102 F.2d 89, 90 (5th Cir. 1939).

Neither the Internal Revenue 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 (1941) in which the Supreme Court stated that, "[h]istorically and commonly insurance involves risk shifting and risk distributing". Id. 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". 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, 66 T.C. 1068 (1976), aff'd, 572 F.2d 1190 (7th Cir. 1978), 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 loss to the insurer. 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 proceeds. See Rev. Rul. 92-93, 1992-2 C.B. 45 (permitting a parent company to deduct the premiums paid to the insurance subsidiary for group-term life insurance on an employee of the parent.)

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). 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 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 a company needs per risk unit to remain at a given level of solvency. See Rev. Rul. 89-61, 1989-1 C.B. 75.

Based on the description of the ESAs, we conclude those contracts are insurance contracts and not prepaid service contracts. Unlike prepaid service contracts, the ESAs are aleatory contracts under which Primary Obligor, for a fixed price, is obligated to indemnify a Contractholder for the economic loss arising from the failure of a system or a part during the contract period. Because Primary Obligor does not provide any repair services, the contracts are not prepaid service contracts. Further, by accepting a large number of risks, Primary Obligor distributed the risk of loss under the ESAs so as to make the average loss more predictable.

Based on the facts and representations as stated above, it is held that for federal income tax purposes:

(i) the ESAs issued by Primary Obligor are insurance contracts; and,

(ii) Primary Obligor will be an insurance company within the meaning of section 831 and the regulations thereunder so long as its primary and predominant business is issuing ESAs.

Taxpayer states that Primary Obligor includes in its gross written premiums the entire amount Contractholders pay to the Dealers in connection with their acquisition of the ESAs, and that Primary Obligor treats as a commission expense an amount equal to the difference between that amount, and the amount the Dealers are contractually obliged to pay to the Administrator. No ruling has been requested, and no opinion is expressed, regarding whether Primary Obligor's gross premiums include the entire amount the Contractholders pay to the Dealers in connection with their acquisition of the ESAs, or whether any amount is deductible as a commission expense.

Further, no opinion is expressed as to the tax treatment of the transactions discussed herein under the provisions of any other section of the Code and regulations which may also be applicable, or to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction which are not specifically covered by the above holdings.

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

A copy of this letter should be attached to Taxpayer's next tax federal income tax return.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions and Products)

By: SIGNED DONALD J. DREES, JR.
Donald J. Drees, Jr.
Senior Technician Reviewer
Branch 4