**Internal Revenue Service**

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Department of the Treasury
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Person To Contact:
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Telephone Number:

Refer Reply To:
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Date:
May 04, 2006

Legend

Taxpayer =

State X =

Dealers =

Insurance Company =

Administrator =

Dear :

This responds to your letters dated December 23, 2005, March 22, 2006, April 14, 2006, and April 25, 2006 requesting rulings that: (1) extended warranty contracts (EWCs) issued by Taxpayer are insurance contracts for federal income tax purposes, and (2) Taxpayer qualifies as an insurance company under section 831(a) of the Internal Revenue Code.

## FACTS

Taxpayer is a corporation organized under the laws of State X. Taxpayer is not regulated as an insurance company under the laws of State X. Taxpayer files its federal income tax return on a calendar year basis and uses the accrual method of accounting.

Taxpayer issues EWCs for new and used vehicles. Dealers offer their customers the opportunity to purchase Taxpayer's EWCs when they buy a vehicle. When a Dealer

sells an EWC, the Dealer collects the amount paid and remits a specific portion to Taxpayer. Taxpayer and the Dealers are controlled by the same three shareholders.

The EWCs indemnify the purchaser (contract holder) against economic loss for certain expenses to repair a vehicle that has had a mechanical breakdown, provided the expenses are not covered by the manufacturer's warranty. In addition, the EWCs offer limited coverage for a portion of the cost of substitute transportation and roadside assistance that is necessitated by a mechanical breakdown. Taxpayer does not provide repair services. Taxpayer is only liable for reimbursing the repair facility, or the contract holder, for costs covered by the EWCs.

The EWCs do not cover a contract holder's expenses for: (1) preventative or routine maintenance; (2) events that would normally be covered by casualty insurance, such as collisions, accidents, fires, floods, vandalism, etc.; (3) improper use of the vehicle, i.e., commercial use; and (4) incidental or consequential damages, other than a portion of the costs for substitute transportation and roadside assistance under the limited circumstances set forth in the EWC. Furthermore, the EWCs limit the total amount payable under the agreement to the retail price the contract holder paid for the vehicle, and limit the amount payable per repair to the cash value of the vehicle at the time of the repair.

The contract holder elects the maximum number of months and the maximum number of miles the EWC will cover. The term of the contract is whichever event occurs first.

Although Taxpayer is the primary obligor of the EWCs, to satisfy State X's state law requirements, Taxpayer has entered into a contractual liability insurance policy (CLIP) with Insurance Company, an unrelated, licensed insurance company, under which Insurance Company is liable to the contract holder in the event Taxpayer is unable to pay a claim, i.e., Taxpayer goes bankrupt. Taxpayer has also entered into a program administration agreement with Administrator, an unrelated third party, pursuant to which Administrator provides some of the administrative services of Taxpayer's EWC business.

Taxpayer represents that it intends to engage solely in the business of issuing EWCs. Therefore, Taxpayer anticipates that, for each year it is in business, its gross receipts derived from issuing EWCs will comprise a substantial majority of its total gross receipts.

## LAW AND ANALYSIS

Section 831(a) of the Internal Revenue Code provides that taxes, as computed in section 11, will be imposed on the taxable income (as defined by section 832) of each insurance company other than a life insurance company. Section 831(c) defines the

term “insurance company,” for purposes of the section, as having the same meaning as that term is given under section 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.

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

Section 1.801-3(a)(1) 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 Internal Revenue 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 that taxpayer was an insurance company as defined in section 1.801-3(a)(1), notwithstanding that taxpayer was not recognized as an insurance company for state law purposes). To qualify as an insurance company, a taxpayer “must use its capital and efforts primarily in earning income from the issuance of contracts of insurance.” Indus. Life Ins. Co. v. United States, 344 F. Supp. 870, 877 (D.S.C. 1092), aff’d per curiam, 481 F.2d 609 (4th Cir. 1973), cert. denied, 414 U.S. 1143 (1974). To determine whether a taxpayer qualifies as an insurance company, all relevant facts will be considered, including but not limited to, the size and activities of its staff, whether it engages in other trades or businesses, and its sources of income. See generally, Bowers, 285 U.S. 182; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F.Supp. 387, 391-92 N.D. Tex. 1969), rev’d on other grounds, 293 F.2d 72 (8th Cir. 1961); Inter-Am. Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff’d per curiam, 469 F.2d 697 (9th Cir. 1971); Nat’l Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933).

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, 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 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). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-

91 (2d. Cir. 1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs if 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 premiums 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 can smooth out losses to match more closely its receipt of premiums. See Clougherty Packing Co., 811 F.2d at 1300.

The "commonly accepted sense" of insurance derives from all the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with that of known insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of an arrangement under the applicable state law, AMERCO, Inc. v. Commissioner, 96 T.C. 18, 41 (1991); the adequacy of the insurer's capitalization and utilization of premiums priced at arm's length, The Harper Group v. Commissioner, 96 T.C. 45, 60 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728 (1991), aff'd per curiam, 988 F.2d 1134 (Fed. Cir. 1993); and the language of the operative agreements and the method of resolving claims, Kidde Indus. Inc. v. United States, 49 Fed. Cl. 42, 51-52 (1997).

A contract providing benefits in kind, rather than in cash, may constitute an insurance contract for federal income tax purposes. Commissioner v. W.H. Luquire Burial Ass'n Co., 102 F.2d 89, 90 (5th Cir., 1939); § 1.213-1(e)(4).

Based on the information submitted, we conclude that Taxpayer's EWCs are insurance contracts for federal income tax purposes. The EWCs are aleatory contracts under which Taxpayer, for a fixed price, is obligated to indemnify the contract holder for certain economic losses, which are not covered by the manufacturer's warranty, that result from the vehicle's mechanical breakdown. Thus, during the contract period, the contract holder has limited its loss for covered risks to the payment of the contract purchase price. In this way, each contract holder has shifted its risk of economic loss to

the Taxpayer. By issuing EWCs to a large number of contract holders, Taxpayer has assumed numerous, independent, and homogeneous risks. In this way, Taxpayer has distributed the risk of loss under the EWCs so as to make the average loss more predictable.

Taxpayer represents that it intends to engage solely in the business of issuing EWCs, which we conclude are insurance contracts. So long as more than half of Taxpayer's business is issuing insurance contracts, Taxpayer will qualify as an "insurance company" for purposes of section 831(a).

## CONCLUSIONS

(1) The EWCs issued by Taxpayer, as described above, are insurance contracts for federal tax purposes.

(2) In 2005 and later years, Taxpayer will be taxable under section 831(a) as an insurance company other than a life insurance company, so long as more than half its business during the taxable year is the issuance of EWCs.

## CAVEATS

(1) Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect or item discussed or referenced in this letter.

(2) No opinion is expressed regarding the tax status of Taxpayer as an insurance company for any year before 2005.

The rulings contained in this letter are based on the information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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. Code section 6110(k)(3) 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 first listed representative.

Sincerely,

/s/

Mark Smith
Chief, Branch 4
Office of Assistant Chief Counsel
(Financial Institutions & Products)