INTERNAL REVENUE SERVICE

Number: **200147052**
Release Date: 11/23/2001
UIL Nos. 61.09-00; 451.00-00; 831.03-00; 832.00-00

CC:FIP:4/PLR-110054-01
August 28, 2001

Legend

Company =

Parent =

State A =

Reinsurer =

Country B =

Contract =

A =

C =

e =

q =

x =

y =

z =

Dear

This responds to letters dated February 12, April 25, May 24, June 20 and July 20, 2001 in which Company requested certain rulings. The requested rulings involve (1) whether contracts under which Company provides coverage for certain products against mechanical breakdown (beyond the warranties provided by the manufacturer or retailer) qualify as insurance contracts,and (2) whether Company will be treated as an insurance company for federal income

tax purposes.

FACTS

Company will be incorporated in State A as a general business corporation. Company will not be recognized as an insurance company under the laws of State A.[1] Company's entire business will relate to the issuance of the mechanical breakdown contracts to be described below. All of the stock of Company will be owned by Parent.

Parent, which is also incorporated under the laws of State A, is the parent of an affiliated group of companies that files a consolidated federal income tax return which will include Company as a member. Parent is also engaged in business as a providing multiple merchandise lines of goods. In addition, a portion of Parent's business activities relate to the provision of e services.

Reinsurer is a Country B reinsurance company for which an election will be made under § 953(d) of the Code to be treated as a domestic corporation taxable in the United States. Reinsurer will be a member joining in Parent's consolidated federal income tax return. All of Reinsurer's stock is owned by Parent. Reinsurer currently reinsures risks under various arrangements sold by Parent and will be utilized, as described below, to reinsure some or all of the risks that Company will assume under the mechanical breakdown contracts that Company will issue.

As indicated above, Company's only business activity will be the issuing of mechanical breakdown contracts (the Contracts) obligating Company to pay a qualified repair facility for repairs to or for the replacement of covered products purchased by customers. The merchandise lines upon which Company will offer the Contracts will be on certain merchandise lines sold by Parent. (Company will not sell the Contracts on all of Parent's merchandise lines, e.g., some of Parent's products are of more of a disposable nature which would not be proper subjects for the Contracts.) In Exhibit A, which is attached, there is a list of the current Merchandise Lines for which Company plans to issue the Contracts.[2] The Contracts provide that in exchange for

---

[1] Company will be licensed or registered as a service contract issuer under the laws of State A as well as the service contract legislation of approximately 20 states that currently have such legislation. In addition, it is anticipated that in several additional states Company will fit into exceptions from insurance law licensing or registration requirements or will obtain clearance from insurance regulators to issue contracts providing certain coverage against mechanical breakdown.

[2] Typically, the Contracts issued by Company will cover products selected by customers from Merchandise Lines offered in Parent's stores upon which Company offers Contracts. The Contracts will also be issued covering products purchased at other stores. (The Contracts issued with respect to products offered by stores other than Parent's stores, however, will only be those products that will be able to be characterized into the then current

Consideration paid by the purchaser of the Contract, Company, as the obligor on the Contract, will pay on the purchaser's behalf for the cost of parts and services performed by a qualified repair facility that Company may designate necessary to maintain the proper operating condition for the underlying product. Generally, the term of the Contract begins on the date when the customer takes possession of the underlying product (or some later date after the product has been purchased) and expires at a specified time.[3] Parts and service under any warranty will be provided under that warranty.

In addition to this indemnity feature, most of the Contracts contain a paragraph that provides that at the request of the purchaser of the Contract, Company will pay Parent's A division to perform an annual preventative maintenance check-up on any covered product. The checks include such activities as adjustments, changing of fluids, cleaning of internal components, inspections, testing and tuning of a purchased product unrelated to the loss event of a mechanical breakdown. Depending upon the particular product and (the Contract) option purchased, the annual check, if requested, (as well as the indemnity work resulting from a mechanical breakdown) may be conducted in the home of the purchaser of the product or at Parent's facilities.

The Contracts will be marketed at Parent stores through telemarketing, and by Parent's A division repair technicians. The marketing of the Contracts will feature both the indemnity protection that the purchaser of the product will secure against mechanical breakdown of that product and the ability of the purchaser to request a check of the product. The Contracts, which will cover products purchased at both Parent's stores and other stores, do not duplicate coverage provided under the warranties of the manufacturer and retailer.

It is expected that Company will have between y and z employees. The primary activities of the Company employees will be the development of policy and products, oversight over the sales activities and marketing, oversight of claims, entering into and maintaining arms-length relationships with related and unrelated third parties and accumulating data for operations, finance and business development. Company will not itself provide any repair services. It is anticipated that Company will contract with Parent's repair division for the provision of most repair and maintenance services in certain circumstances. For example, Company will utilize unrelated companies or individuals for the repair and maintenance operations under the Contracts for consumer products sold by Parent's C division. Company will also rely on unrelated independent contractors for the provision of repair and maintenance services for the Contracts sold in certain rural areas.

Company will transact the Contract business as a third-party obligor in those states which

---

Merchandise Lines for which Company plans to issue the Contracts.)

[3] The Contracts will be priced based upon a number of factors such as the length of the term of the coverage requested by the purchaser of the Contract and the experience of a Merchandise Line and the underlying products within that line (to include whether work on the product is going to require a visit to the purchaser's home).

permit third-party obligor arrangements and do not regulate the Contracts as insurance. In order to comply with state law requirements, Company will maintain assets with a value of more than $x. Further, Company will satisfy state regulatory requirements. In addition, Company will reinsure a significant portion of the original risk assumed by Company under the Contracts with Reinsurer, however, pursuant to Representation (f) below Company will not currently deduct any coverage it obtains from Reinsurer with respect to the portion of its obligation as a premium paid for reinsurance under § 832(b)(4). As indicated above, Reinsurer currently reinsures risk under various credit agreements sold by Parent; Having Company reinsure with Reinsurer will allow Parent to consolidate in one entity all of its reinsurance businesses. Company, however, as the obligor on the Contracts will in all cases remain directly liable to the retail buyers of the Contracts.

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

(a) None of the Contracts issued by Company will cover the payment of costs for which the manufacturer or retailer of the product would be liable for under a base warranty (express or implied).

(b) Fees for the repair and maintenance services provided through Parent's A division will be calculated on a fee for service basis and will be charged to Company at the same arms-length rates charged to third parties.

(c) Company represents that a list of the current Merchandise Lines for which it plans to issue the Contracts is attached as Exhibit A. The list of Merchandise Lines may change from year to year.

(d) Company represents that for each Merchandise Line for which a Contract will be issued that includes a (preventative maintenance) provision, the portion of the total Contract premium allocable to the provision will not exceed q%.

(e) If the portion allocable to the provision exceeds q% for any year for a Merchandise Line, Company will treat the Contract premium for that Merchandise Line for that year in its entirety as advance payments for services and not as an insurance premium.

(f) Company represents that it will treat each year as advance payments for services pursuant to Schlude v. Commissioner, 372 U.S. 128 (1963) an amount equal to that portion of the total Contract premium for each Merchandise Line allocable to the provision. Company further represents that the portion of the premium for the Contract will be determined based on Company's costs, including direct and indirect costs, and a profit element, attributable to the provision.

Company further represents that it will either retain such Schlude income and the obligations related thereto, or if it transfers the obligations to Reinsurer, it will not treat the consideration for the assumption of such obligations by Company as

currently deductible reinsurance premiums under § 832(b)(4).

(g) Company represents that its primary and predominant business activity is the issuing of the Contracts. To the extent that a portion of its revenues are attributable to the provision of its Contracts, Company represents that its primary and predominant business activity is not the providing of preventative maintenance services or other services not integral to the indemnity feature of the Contract.

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)(1)(C) provides (with an exception not relevant here) that gross income includes all other items constituting gross income under subchapter B of the Code (e.g., including services income under § 61). 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 determine 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 1.831-3(a) of the Income Tax Regulations provides that, for purposes of §§ 831 and 832 of the Code, the term "insurance companies" means only those companies that qualify as insurance companies under the definition in former § 1.801-1(b) (now § 1.801-3(a)(1)) of the regulations.

Section 1.801-3(a)(1) of the regulations 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. Section 1.801-3(a)(1) further 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 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 the taxpayer was an "insurance company," as defined in § 1.801-3(a)(1), notwithstanding that the taxpayer was not

recognized as an insurance company for state law purposes).

Section 61(a)(1) of the Code provides that, except as otherwise provided in Subtitle A, gross income means all income from whatever source derived, including (but not limited to) compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 451(a) of the Code provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly be accounted for as of a different period. Section 1.451-1(a) of the regulations provides that under an accrual method of accounting income is includible in gross income when all the events have occurred that fix the right to receive the income and its amount can be determined with reasonable accuracy. See also § 1.446-1(c)(1)(ii)(A) (same regulatory language). A number of cases have been decided by the Supreme Court dealing with prepaid income. In Automobile Club [of Michigan] v. Commissioner, 353 U.S. 180 (1957), and American Automobile Assn. v. United States, 367 U.S. 687 (1961), the Supreme Court was confronted with accrual basis taxpayers who, after receiving in advance dues from their members, sought to defer part of the dues until the next taxable year. In American Automobile Assn., the Court held that the Commissioner did not abuse his discretion in rejecting the taxpayer's method of accounting that attempted to spread the taxation of prepaid dues beyond the year of actual receipt and, thus, approved the Commissioner's ability to require the taxation of such dues in the year of receipt. In Schlude v. Commissioner, supra, the Supreme Court, in upholding the Commissioner's determination that the cash receipts, negotiable notes received, and contract installments due and payable during the year were taxable currently, found the issue to be squarely controlled by the American Automobile Assn. case. The Court relied upon the fact that "the advance payment related to services which were to be performed only upon the customer's demands without relation to fixed dates in the future." The Court, quoting from Spring City Co. v. Commissioner, 292 U.S. 182 (1934), to the effect that "it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income" of an accrual basis taxpayer, and citing Commissioner v. Hanson, 360 U.S. 446 (1959) found that the right to receive the contract installments "had become fixed at least at the time they were due and payable." In the first three Supreme Court cases referred to above in this paragraph, payment was received in advance by accrual basis taxpayers. In Automobile Club [of Michigan] and American Automobile Assn. payment was in the form of cash and negotiable promissory notes. In Schlude payment was in the form of cash and negotiable promissory notes. It was this fact of payment that required the amounts received to be included in income in the year of receipt even for accrual basis taxpayers.

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. 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 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, 2001-26 I.R.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 Clougherty Packing Co., 811 F.2d at 1300.

Based on the information submitted, we conclude that, for federal income tax purposes, the non- portion of the Contracts are insurance contracts, not prepaid service contracts. Unlike prepaid service contracts, the non- portion of the Contracts are aleatory contracts under which Company, for a fixed price, is obligated to indemnify the purchaser of the Contract for economic loss not covered by warranties provided by a manufacturer or a retailer, arising from the mechanical breakdown of, and repair expense to, a purchased covered product. Thus, the non- portion of the Contracts are not prepaid service contracts because Company's liability is limited to indemnifying the holder of the Contract for losses in the event a mechanical breakdown occurs. Company does not provide any repair services itself and services that the Company will provide to the holder of the Contract will be treated as services income to Company under Representations (e) and (f) above. Further, by accepting a large number of independent, homogenous risks in each of its Merchandise Lines, Company has distributed the risk of loss under the qualifying contracts so as to make the average loss more predictable. Finally, based on Company's representations, we conclude that, under § 1.801-3(a)(1) of the regulations, Company qualifies as an "insurance company" for purposes of § 831 of the Code.

CONCLUSIONS

Accordingly, based solely on the information and representations made and provided that Company complies with representations (a) through (g) above, it is concluded as follows:

(1) Except for any of the Contracts treated by Company as contracts for services in their entirety in accordance with representation (e) above, the portion of each Contract that is not allocable to the provision will be treated as an insurance contract for purposes of § 1.831-(3) of the regulations.

(2) Company qualifies as an insurance company for federal income tax purposes.

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 what amount, if any, paid by the purchasers of the Contracts and retained by Parent or other retailer is deductible as a commission expense by Company.

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(s) 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 Company.

Sincerely yours,
DONALD J. DREES, JR.
Senior Technician Reviewer
Branch 4
Office of Associate
Chief Counsel
(Financial Institutions & Products)

Exhibit A

List of Merchandise Line in Force