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Legend

Taxpayer	=
Country N	=
Dealership O	=
Dealership R	=
State U	=
State V	=
Finance Company W	=
Finance Company X	=
Insurance Company Y	=
Broker Z	=

Dear :

This is in response to the letter submitted by your authorized representatives dated March, 7, 2013, requesting a ruling that certain contracts are insurance contracts and that Taxpayer qualifies as an insurance company for federal income tax purposes.

FACTS

Taxpayer represents it is an insurance company organized and regulated under the laws of Country N.

Dealership O and Dealership R (collectively, the "Dealerships") are in the business of selling used vehicles at their dealer locations in State U and State V, respectively. In connection with this business activity, the Dealerships extend credit to the purchasers of the vehicles ("customers"). The vehicles purchased are used as collateral for the loans written. Subsequent to issuing a loan to a customer, a Dealership sells the newly originated loans to Finance Company W and Finance Company X (collectively, the "Finance Companies"). The Finance Companies are in the business of servicing and collecting consumer notes issued for the purchase of used vehicles.

Under the terms of the financing arrangement, a customer agrees to maintain property insurance on the vehicle, protecting against loss and physical damage. A customer is in default under the terms of the financing agreement if he or she fails to obtain and maintain the required insurance, and the Finance Companies may repossess the vehicle or purchase a collateral protection policy, which protects against the loss of or damage to the vehicle, from Insurance Company Y. If the Finance Companies exercise the option to purchase a collateral protection policy, the customer agrees to pay for the cost of the collateral protection policy. The Finance Companies will list the cost of the collateral protection policy as a separate line on the customer's invoice and such amount is immediately due by customer. Taxpayer represents that if the customer fails to pay the cost of the collateral protection policy, the Finance Companies will cancel the collateral protection policy and the customer will be in default of his or her loan.

Insurance Company Y obtains a quota share reinsurance contract from Broker Z to reinsure its risk under the collateral protection policies obtained by the Finance Companies. Broker Z then obtains a quota share reinsurance contract from Taxpayer to reinsure the risk it accepted for the collateral protection policies under its reinsurance contract with Insurance Company Y. Taxpayer represents Insurance Company Y and Broker Z qualify as insurance companies for federal income tax purposes.

In connection with its business activities, Dealership O offers for sale a Motor Vehicle Service Contract ("MVSC"), which provides a purchaser (customer), subject to certain limitations, with protection against economic loss for certain expenses related to the repair of specified systems and covered parts of the vehicle. The MVSC does not cover any repair covered by the manufacturer's warranty, or repairs required because of, among other things, collision, abuse, or lack of reasonable and proper maintenance. The MVSC provides that all obligations and liabilities for repairs covered by the agreement are those of Dealership O. The MVSC is sold separately from the vehicle, so a customer must specifically elect to purchase the MVSC and pay an additional consideration that is separate from the purchase price of the vehicle.

To facilitate performance of its obligations under the MVSCs, Dealership O purchases from Taxpayer indemnity insurance agreements, which are intended to constitute reinsurance arrangements. The indemnity insurance agreements reimburse Dealership

O for repair expenses incurred in connection with its obligations under the MVSCs. Dealership O remains primarily liable to the holders (the customers) of the MVSCs.

Taxpayer represents that more than half of its business is the reinsurance of the collateral protection contracts and the issuing of indemnity insurance agreements for the MVSCs. Taxpayer also represents that it will maintain adequate statutory reserves to pay claims.

LAW AND ANALYSIS

Section 831(a) of the Internal Revenue Code (the “Code”) provides that taxes, computed as provided in § 11, are imposed for each taxable year on the taxable income of each insurance company other than a life insurance company. Section 831(c) provides that, for purposes of § 831, the term “insurance company” has the meaning given to such term by § 816(a). Under § 816(a), the term “insurance company” means “any company more than half the business of which during the taxable year is issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.”

Taxpayer’s primary and predominant activity is the reinsuring of the collateral protection policies and issuing of indemnity insurance agreements for the MVSCs. Taxpayer’s qualification as an insurance company for federal income tax purposes therefore depends on whether this activity constitutes issuing an insurance contract or reinsuring the risks underwritten by an insurance company.

Neither the Code nor the regulations define the terms “insurance” or “insurance contract.” The standard for evaluating whether an arrangement constitutes insurance for federal tax purposes has evolved over the years and is, at best, a nonexclusive facts and circumstances analysis. Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 861-64 (7th Cir. 1992). The most frequently cited opinion on the definition of insurance is Helvering v. LeGierse, 312 U.S. 531 (1941), in which the Court describes “insurance” as an arrangement involving risk-shifting and risk-distributing of an “insurance risk” determined at the time the transaction was executed. Cases analyzing “captive insurance” arrangements have described the concept of “insurance” for federal income tax purposes as containing three elements: (1) involvement of an insurance risk; (2) shifting and distributing of that risk; and (3) insurance in its commonly accepted sense. See e.g., AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff’g. 96 T.C. 18 (1991). The test, however, is not a rigid three-prong test.

The risk transferred must be a risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-291 (2d Cir. 1950), and must not be merely an investment or business risk. LeGierse, 312 U.S. at 542; Rev. Rul. 2007-47, 2007-2 C.B. 127; Rev. Rul. 89-96, 1989-

2 C.B. 114. In addition, the arrangement must constitute insurance in the commonly accepted sense.

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, such that a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer. 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. By assuming numerous relatively small independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

Courts have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. Humana v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989). See also Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135, 1153 ("Risk distribution involves spreading the risk of loss among policyholders."); Beech Aircraft Corp. v. U.S., 797 F.2d 920, 922 (10th Cir. 1986) ("[R]isk distributing means that the party assuming the risk distributes his potential liability, in part, among others.") Thus, purported insurance arrangements that involve an issuer who contracts with only one policyholder do not qualify as insurance contracts for federal income tax purposes. Rev. Rul. 2005-40.

The "commonly accepted sense" of insurance derives from all of 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, AMERICO, Inc., 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 1135 (Fed. Cir. 1993); and the language of the operative agreements and the method of resolving claims, Kidde Indus. Inc. v. Commissioner, 40 Fed. Cl. 42, 51-52 (1997).

In order to determine the nature of an arrangement for federal income tax purposes, it is necessary to consider all the facts and circumstances in a particular case, including not only the terms of the arrangement, but also the entire course of conduct of the parties. Thus, an arrangement that purports to be an insurance contract but that lacks the requisite insurance risk, or fortuity, may instead be characterized as a deposit arrangement, a loan, a contribution to capital (to the extent of net value, if any), an option or indemnity contract, or otherwise, based on the substance of the arrangement between the parties. The proper characterization of the arrangement may determine

whether the issuer qualifies as an insurance company and whether amounts paid under the arrangement may be deductible.

In considering the present case we are mindful of the observation of the Court that interrelated contracts must be considered together. Le Gierse, 312 U.S. at 540. See also Clougherty Packing Co., 811 F.2d at 1301 ("Where separate agreements are interdependent, they must be considered together so that their overall economic affect can be assessed.")

As part of the financing arrangement, a customer is obligated to maintain property insurance on the vehicle to protect against loss and physical damage. If the customer fails to obtain the required insurance, the Finance Companies may obtain a collateral protection policy and charge the customer for the coverage. The collateral protection policy fulfills the customer's obligation to maintain required property insurance, providing protection from the economic loss of (or damage to) the vehicle, as long as the customer continues to pay for the coverage. The economic risk which is shifted first from customer to Insurance Company Y, then to Broker Z, and ultimately to Taxpayer is an insurance risk and the coverage provided is in accord with the commonly accepted sense of insurance. Taxpayer represents that Insurance Company Y and Broker Z qualify as insurance companies for federal income tax purposes. Hence, by entering into its arrangement with Broker Z, Taxpayer is reinsuring risks within the meaning of §§ 816(a) and 831(c).

Under the MVSCs, Dealership O assumes the risk of economic loss from the customers for the cost of repairs of specified components of the vehicles, but only for those vehicles subject to a MVSC. Customers have the option to self-insure by not purchasing a MVSC. Customers can also choose to purchase an extended warranty contract from a different insurance company. The amounts paid by the customers to purchase MVSCs are pooled so that no individual customer is in any significant part paying for his or her own risk of loss. Considering together the MVSCs and the indemnity insurance agreement, the effect is to shift to Taxpayer the risk of loss from the purchasers of the MVSCs. The risk of loss which is shifted ultimately to Taxpayer is an insurance risk and the coverage provided to the purchasers is in accord with the commonly accepted sense of insurance. Had Taxpayer issued the MVSCs directly to the customers, the agreements collectively would constitute a block of insurance business for federal income tax purposes. Likewise, were Dealership O an insurance company, Taxpayer's role as a reinsurer would not be questioned.

CONCLUSION

Both the collateral protection policies and the MVSCs are insurance contracts for federal income tax purposes. Taxpayer represents that more than half of its business is the reinsurance of the collateral protection contracts and the issuing of indemnity

insurance agreements for the MVSCs. Therefore, Taxpayer qualifies as an insurance company for federal income tax purposes.

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

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

The rulings contained in this letter are based upon information and representations submitted by the 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.

Sincerely,

Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)